DOCUMENT RESUME

ED 386 112 HE 028 520

TITLE	College Savings: Information on State Tuition Prepayment Programs. Report to Congressional Requesters.
INSTITUTION	General Accounting Office, Washington, DC. Health, Education, and Human Services Div.
REPORT NO	GAO/HEHS-95-131
PUB DATE	Aug 95
NOTE	111p.
AVAILABLE FROM	U.S. General Accounting Office, P.O. Box 6015, Gaithersburg, MD 20884-6015 (first copy free; additional copies $2 each; 100 or more copies discounted 25%).
PUB TYPE	Legal/Legislative/Regulatory Materials (090)
EDRS PRICE	MF01/PC05 Plus Postage.
DESCRIPTORS	Community Colleges; *Enrollment; Higher Education; Income; *Paying for College; Program Descriptions; *Program Evaluation; School Choice; *State Programs; State Universities; Taxes; *Tuition
IDENTIFIERS	Alabama; Alaska; Florida; Michigan; Ohio; Pennsylvania; *Prepayment Plans; *Tuition Prepayment; Wyoming

ABSTRACT

This report examined state tuition prepayment programs (STPPs) in Alabama, Alaska, Florida, Michigan, Ohio, Pennsylvania, and Wyoming, focusing on how the programs operate and the participation rates they have achieved. It also assessed the income level of program participants, options for increasing the participation of lower-income families, and key issues surrounding STPPs. The report found that while the seven programs studied all operated similarly, they also had many unique features that distinguished them from one another. Existing programs have also achieved varying overall participation rates. Most participants in STPPs come from middle- and upper-income families, largely due to the lack of discretionary income among low-income families. Key issues surrounding such programs include: (1) the applicability of federal tax provisions; (2) the potential effect STPPs have on students' educational choices; (3) their appeal to mostly middle- and upper-income families; (4) their value as an investment for purchasers; and (5) the degree of risk they pose for states. Four appendixes provide an overview of program features, additional problems that states may encounter in establishing and operating STPPs, federal taxation issues related to STPPs, and General Accounting Office contacts and staff acknowledgements. (Contains 115 references, 6 tables, and 9 figures.) (MDM)

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United States General Accounting Office

GAO

Report to Congressional Requesters

August 1995

COLLEGE SAVINGS

Information on State Tuition Prepayment Programs

ED 386 112

HE028 520

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Washington, D.C. 20548

Health, Education, and
Human Services Division

B-254026

August 3, 1995

The Honorable Nancy Landon Kassebaum
Chairman, Committee on Labor and
Human Resources
United States Senate

The Honorable James M. Jeffords
Chairman, Subcommitee on Education,
Arts, and the Humanities
Committee on Labor and Human Resources
United States Senate

The Honorable Thad Cochran
United States Senate

In response to your request, this report presents the results of our study of state tuition prepayment programs. These programs represent one approach that some states have adopted to encourage families to save for their children's college educations.

Copies of this report are also being sent to appropriate congressional committees, the Secretary of Education, the Commissioner of the Internal Revenue Service, and other interested parties.

This report was prepared under the direction of Wayne B. Upshaw, Assistant Director, who may be reached on (202) 512-7006 if you have any questions about it. Other major contributors are listed in appendix IV.

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Executive Summary

Purpose

In the 1980s, several factors combined to create the perception of a college affordability crisis. From 1980 to 1987, the total cost of college attendance increased by an average of almost 9 percent annually, while median family income grew by an average of less than 6 percent. Also, student financial aid did not keep pace with rising college costs, and the mix of aid changed from mostly grants to loans, contributing to concerns about excessive student debt.

In light of these trends, government officials at both the state and federal levels developed numerous proposals to encourage families to save for college. A handful of states adopted a tuition prepayment program, allowing parents or others to pay in advance for tuition at participating colleges on behalf of a designated child and guaranteeing to cover the child's future tuition bill at one of these colleges, no matter how much costs rise. By allowing purchasers to "lock in" today's prices, these programs are intended to ease families' concerns about whether they will have sufficient funds in the future to pay for their children's college educations.

The Chairman of the Senate Committee on Labor and Human Resources; the Chairman of the Subcommittee on Education, Arts, and the Humanities; and Senator Thad Cochran asked GAO for information on state tuition prepayment programs. GAO agreed to (1) describe how these programs operate and the participation rates they have achieved, (2) assess participants' income levels and options for increasing the participation of lower-income families, and (3) discuss the key issues surrounding these programs. To address these objectives, GAO reviewed the literature, interviewed key program officials and other people knowledgeable about these programs, and analyzed data on program participants and other residents of these states.

Background

In 1986, Michigan became the first state to create a tuition prepayment program—the Michigan Education Trust (MET). At least a dozen other states have followed Michigan's lead by authorizing such programs, but only seven had implemented their programs by 1994: Alabama, Alaska, Florida, Michigan, Ohio, Pennsylvania, and Wyoming. The programs operate as follows. Purchasers pay in advance for educational benefits that a designated beneficiary is expected to use in the future at participating institutions, usually in-state public colleges. The program pools all payments into one large fund and invests it with the goal of achieving a rate of return that is higher than the rate of tuition increases anticipated at participating colleges. When the beneficiary enrolls at a participating college, the program pays to the school whatever it charges at that time for tuition and fees and any other prepaid expenses, such as housing costs.

Results in Brief

Although the seven programs GAO studied all operate similarly, they also have many unique features that distinguish them from one another. Existing programs have also achieved varying overall participation rates. The factors that program officials emphasized as important for maximizing participation include (1) effective advertising and marketing, (2) a positive public perception of the program, (3) simple and flexible program features, and (4) affordably priced benefits.

Most participants in state tuition prepayment programs come from middle- and upper-income families; lower-income families are underrepresented. When asked about the potential of two options—sliding-scale fees and a tax credit—for increasing participation among lower-income families, program officials said the former option would pose too great an administrative burden, and some questioned the effectiveness of the latter option. Although officials have tried to make program benefits affordable for all families, substantially increasing the participation of lower-income families will probably be difficult, given their lack of discretionary income.

Four major issues concerning these programs are (1) the potential effect they have on students' educational choices; (2) their appeal to mostly middle- and upper-income families, and the possibility that such families receive subsidies through participation; (3) their value as an investment for purchasers; and (4) the degree of risk they pose for states. The most significant issue facing these programs, however, is the potential applicability of federal tax provisions. Nearly 8 years after the first state tuition prepayment program started operating, questions remain unresolved about the potential tax liability of purchasers, beneficiaries, and the programs themselves. Officials are concerned because certain federal tax consequences could make it difficult to operate these programs successfully. Federal legislation could resolve this issue quickly and favorably. However, certain factors would need to be considered, such as the potential cost to the federal government in terms of lost tax revenues and possible negative effects on private sector institutions competing for college savings dollars.

Principal Findings

States' Experiences in Operating Tuition Prepayment Programs

The seven programs GAO reviewed have followed two approaches to selling prepaid tuition benefits. In Alabama, Florida, Michigan, and Wyoming, purchasers sign contracts to pay for a certain type and amount of benefits. In Florida, for example, purchasers can choose among contracts covering 2 years at a community college, 2 years at a community college plus 2 years at a state university, or 4 years at a state university. With these programs, purchasers also typically can choose between either one lump-sum payment or a long-term payment plan. In Alaska, Ohio, and Pennsylvania, tuition benefits are sold in small amounts, such as credit hours or even smaller units, allowing purchasers to buy whatever amount of benefits they want at any time. In addition to these two different approaches to selling prepaid benefits, each state's program has its own operating rules and unique features.

Existing programs have achieved varying participation rates. For example, Florida's program has sold an average of about 37,000 tuition contracts per year, equivalent to 1.57 percent of nonpoor children in the eligible age range. In contrast, Wyoming's program has sold about 100 contracts per year, which is only 0.14 percent of nonpoor children in the eligible age range.

One factor that program officials described as particularly important for maximizing the total number of participants is an effective advertising and marketing effort to reach potential purchasers. A second key factor is developing and maintaining a positive public perception of the program as a good way to save for college. For example, sales in Ohio decreased about 60 percent last year after the Governor questioned whether the program was a good deal for state families. A third key to maximizing participation is having a simple, flexible program. For example, after Florida's program introduced more flexible rules on using benefits at out-of-state colleges, tuition contract sales increased substantially. A fourth factor officials identified is making program benefits affordable. GAO's analysis found that annual program participation rates are generally higher in states where tuition is more affordable to average-income families.

Participants Relatively Well Off; Lower-Income Families Hard to Reach

Most participants in state tuition prepayment programs come from middle- and upper-income families. For example, in Alabama, Florida, and Ohio, the majority of purchasers reported family incomes of over $50,000 in 1992, while the majority of state families with children had incomes under $30,000. In addition, Alabama state tax returns from 1992 and 1993 revealed that the median income among purchasers was about $61,200, while Bureau of the Census data showed the 1992 median income for all families in the state was about $27,400.

Significantly increasing participation among lower-income families will probably be difficult. States have already tried to make their prepaid benefits affordable; for example, some offer extended payment plans. Also, officials said a sliding-scale fee system would be administratively burdensome, and some questioned whether a tax credit for lower-income purchasers would be effective, because it would not solve the cash-flow problem these families would face in paying for program benefits. Five states have developed plans to provide prepaid tuition scholarships to needy students, but these efforts generally have not lived up to their potential because of funding constraints.

Major Issues Concerning State Tuition Prepayment Programs

One key issue concerning these programs is the effect they might have on beneficiaries' educational choices. A common criticism is that beneficiaries will choose to attend in-state public colleges, because their prepaid benefits will fully cover tuition costs at such schools, even though an in-state private or out-of-state college would better meet their educational needs. GAO found evidence suggesting that most beneficiaries may not believe their educational choices are constrained. Specifically, (1) about 72 percent of all freshmen students in the country enroll at a public college in their home state and (2) some program beneficiaries—18 percent in Michigan, for example—have used the value of their benefits to attend nonparticipating colleges.

A second issue concerning these programs is that they appeal mainly to middle- and upper-income families. Critics are concerned that the programs could subsidize their mostly well-off participants, while doing little to help lower-income families. Supporters say not all programs have to help the poor, and that increased saving by middle-income families may free up financial aid funds for lower-income students. GAO found that these programs can involve various subsidies to participants, such as tax advantages and discounts on benefit prices. However, these programs can also operate without providing these kinds of subsidies. In addition, they likely will not free up substantial financial aid funds for lower-income students.

A third issue concerning these programs is their value as an investment option. Critics say purchasers could earn a better return on their money through other investments, while supporters praise the programs' simplicity, affordability, and the guarantee to cover future costs. GAO found that while purchasers might earn a higher return from other investments, such as stocks, many purchasers may be too risk averse to invest in such options; for example, over 50 percent of purchasers in Alabama indicated that without the prepayment program, they would be depositing their money in a passbook savings account.

A fourth issue for these programs is the degree of risk they pose for states. Critics worry that the programs could create an unfunded liability for the state, while supporters claim the risk of a shortfall can be minimized. GAO's review found that one state suspended new sales several years ago when its program appeared headed for financial trouble, but officials say the program is still actuarially sound. In addition, if a program faced a shortfall, it is unclear which of several possible outcomes might occur, and whether they would be negative is a matter of opinion.

Federal Taxation Most Significant Issue

The most significant issue facing states in establishing and operating a tuition prepayment program is the possible applicability of federal tax provisions to purchasers, beneficiaries, and the programs themselves. This issue is important because certain tax consequences could make it more difficult—perhaps even impossible—for programs to survive. Concerns about taxation have led some states to defer implementation of these programs.

Officials are most concerned about two potential tax consequences. First, officials hope these programs are exempt from federal taxes on their investment earnings, because paying such taxes makes it more difficult to meet future liabilities. What it takes to qualify as exempt, however, is somewhat unclear, in part because the Internal Revenue Service (IRS) and a federal appeals court have disagreed on the tax status of Michigan's program, and also because other existing programs have not received guidance from IRS.

Second, program officials are concerned that IRS may decide purchasers or beneficiaries are liable for federal income taxes annually on the imputed interest earned from their investments in prepaid tuition benefits. Until now, officials have followed guidance that IRS issued for Michigan's program, which said that beneficiaries are liable for taxes on the increased value of their prepaid benefits at the time of redemption. Officials believe that changing from a deferred to an annual tax would create an administrative burden for their programs and a disincentive for potential purchasers.

Agency Comments

GAO discussed a draft of this report with IRS officials, who agreed with the discussion of federal tax issues. The information in this report was also reviewed by officials from all seven state tuition prepayment programs, who agreed with GAO's characterization of the issues and descriptions of their programs. Where appropriate, GAO incorporated minor wording changes suggested by IRS officials and state program officials.

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Abbreviations

CD	certificate of deposit
CPI	Consumer Price Index
CPS	Current Population Survey
IRA	individual retirement account
IRS	Internal Revenue Service
MET	Michigan Education Trust

Chapter 1

Introduction

As the cost of college rose faster than family income for several consecutive years in the 1980s, many people became concerned about the future ability of average American families to afford a college education for their children. In response, both state and federal government officials sought ways to encourage and help families to save for college. One innovative approach, tried in a handful of states, allows people to pay roughly current prices for tuition at participating colleges in exchange for a guarantee that a child's future tuition bill at one of these institutions will be covered, no matter how high costs rise. These programs are known as tuition prepayment programs.[1] Many other states started college savings bond programs for their citizens, and the federal government created a tax advantage for using U.S. savings bonds to pay for college.

College Affordability Became Major Concern in 1980s

In the 1980s, a number of factors combined to create the perception of a college affordability crisis—a perception that persists today. Chief among these factors was the rapid rise in the cost of college attendance, especially relative to income growth and general inflation (see fig. 1.1). From 1980 to 1987, the cost of attendance at U.S. colleges rose an average of 8.8 percent annually. This figure was substantially higher than the growth in median family income during the same period, which increased an average of 5.6 percent per year. Moreover, the increase in college costs was almost twice as great as the average annual increase in the cost of all goods and services, as measured by the Consumer Price Index (CPI), at just 4.7 percent. This pattern was a major reversal from the previous decade: In the 1970s, college costs rose an average of 6.5 percent per year, while median family income and the CPI went up 7.9 percent and 7.8 percent, respectively. However, the general pattern of the 1980s has continued into the 1990s, with college cost increases regularly surpassing general inflation.

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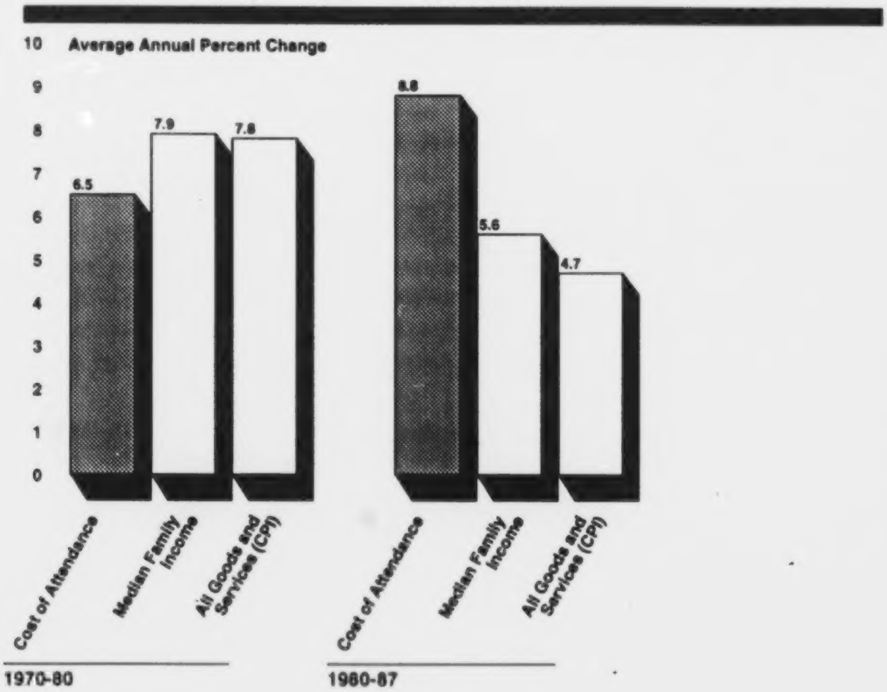
[1] Although all the existing prepayment programs cover mandatory fees in addition to tuition, and some also cover housing and other costs of college attendance, we refer to them simply as "tuition prepayment programs" for the sake of brevity.

Figure 1.1: College Costs Increased Faster Than Income and General Inflation in the 1980s



Source: Arthur M. Hauptman with Jamie P. Merisotis, The College Tuition Spiral: An Examination of Why Charges Are Increasing (New York: Macmillan Publishing Co., 1990), p. 4.

Using recent trends in average college cost increases, analysts often project future prices that can sound astronomical. Last fall, for example, a magazine devoted to planning for college projected that by the time a child born in 1994 is ready for college, the average bill for 4 years of tuition, fees, room and board, books, and transportation would be about $128,000 at a public school and $268,000 at a private one. Given such projections for the cost of a 4-year degree in the future, many Americans worry that a college education might soon be priced beyond their means.

At the same time college costs were climbing faster than family income, the real value of student financial aid was dropping, further contributing to the concern over college affordability. Although total federal aid increased 38 percent in nominal terms from 1980 through 1989, this represented a

1.3-percent decline after adjusting for inflation. And while state and institutionally awarded aid rose by 11 percent in real terms, it did not keep pace with college costs, either. Thus, as one expert put it, "middle-income families, who might have held out hope that financial aid would be available to help with college expenses, awakened to diminished prospects for such assistance at precisely the time that trends in college prices looked especially ominous."[2]

Not only did financial aid fail to keep up with college cost increases, but a shift from grants to loans meant that students were borrowing more than in the past, fueling concern about excessive student debt. In the 1980-81 academic year, grants composed 56 percent of all aid, loans 40 percent, and work-related aid 4 percent. By 1988-89, however, grants had decreased to 48 percent of all aid, loans increased to 49 percent, and work-related aid remained about the same, at 3 percent. In 1976 only 17 percent of tuition costs were financed with loans, but in 1987 the figure was over 50 percent. Finally, student debt increased 60 percent between 1980 and 1987.

In light of these various factors—the rising cost of college, especially compared with increases in family income; declining financial aid in real terms; and increasing levels of student debt—it became apparent that fewer families would be able to finance higher education out of current income while their children were enrolled in college. Thus, many experts concluded that it was increasingly important for parents to plan ahead and save for their children's college educations, so they would have the money in the future, when they needed it. In the mid- to late 1980s, therefore, state and federal government officials began looking for ways to help families to save for college.

States Respond With College Savings Initiatives

Over 30 states have responded to the concern about college affordability by adopting some type of college saving program. In 1986, Michigan became the first state to pass a law establishing a tuition prepayment program. Known as the Michigan Education Trust (MET), the program (1) allowed parents and others to pay for the cost of tuition and fees at a state college years before a child reached college age and (2) guaranteed to cover those costs, no matter how high, when the child eventually enrolled.[3] The idea was a response to the common worry that, given rapid tuition inflation, even people who save for college might not have enough money when their children are ready to enroll.

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[2] Janet S. Hansen, "Pay Now. Go Later. College Prepayment and Savings Plans," The College Board Review, No. 147 (Spring 1988), p. 10.

[3] Because of this guarantee, these programs are sometimes referred to as "guaranteed tuition programs."

The program attracted a great deal of attention nationwide, both in other states and the popular press; in fact, the enactment of MET has been called "the most widely publicized government action in the field of higher education finance during the 1980s."[4] Soon, programs similar to MET were under consideration in as many as 40 states. At least 12 other states have passed laws authorizing a tuition prepayment program, but only 7 had implemented their programs by 1994: Alabama, Alaska, Florida, Michigan, Ohio, Pennsylvania, and Wyoming.[5] Most states that considered the idea of a tuition prepayment program chose instead to adopt a college savings bond program or another type of savings plan.

Tuition Prepayment Programs

Tuition prepayment programs provide a "pay now, learn later" approach to college financing by allowing people to pay in advance for educational benefits that a designated beneficiary will use in the future. The programs charge roughly current prices for tuition and fees and other prepaid benefits, such as dormitory housing—in some cases, a premium may be charged; in others, a discount may be offered. Purchasers may pay for the desired benefits all at once with a lump-sum payment, or with a series of payments over time.

The revenues from purchasers' payments are pooled into one large fund and invested with the goal of achieving a rate of return that exceeds the inflation rate for tuition and fees and other prepaid expenses at participating institutions, typically in-state public colleges. Each semester that the beneficiary enrolls in a participating college, the program pays to the school whatever amount it currently charges for tuition and fees and any other prepaid benefits. If the prepaid benefits are not used as intended—for attendance at an in-state public college—a variety of refund provisions come into play.

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[4] Jeffrey S. Lehman, "The Distribution of Benefits From Prepaid Tuition Programs: New Empirical Evidence About the Effects of Program Design on Participant Demographics," Prepaid College Tuition Plans: Promise and Problems, ed. Michael A. Olivas (New York: College Entrance Examination Board, 1993), p. 28.

[5] Some states, including Indiana and Tennessee, decided against implementation; South Dakota and Virginia are still in the planning stage; Massachusetts implemented its program in February 1995. Detailed descriptions of the tuition prepayment programs in Alabama, Alaska, Florida, Michigan, Ohio, Pennsylvania, and Wyoming are provided in app. I.

College Savings Bonds and Other State Programs

At the state level, the most common initiative has been to establish a college saving bond program. Many states have viewed issuing bonds as less financially risky and easier to administer than tuition prepayment programs. About 20 states have sold college savings bonds, though relatively few have done so on a regular basis. However, these bonds have commonly received a positive response, selling out very quickly.

State college savings bond programs work as follows. The state issues general obligation, zero-coupon bonds, marketed as a way for families to save for future education expenses and targeted at individual, as opposed to institutional, investors.[6] These bonds, similar to U.S. savings bonds, are sold at a discount from their face value and pay no interest until maturity. The bonds typically are valued at $1,000 to $5,000, with maturities ranging from 5 to 20 years. Generally, the bonds cannot be called in early, meaning the issuer cannot redeem them prior to maturity. And because the bonds are state debt instruments, the interest earned is exempt from state taxes (for residents of the issuing state) and federal taxes (for all purchasers). Although the bonds are marketed as a way to save for college, there is no requirement that the funds be spent on college expenses, and purchasers need not have a designated beneficiary.[7] Furthermore, states use the proceeds from college savings bonds as they would proceeds from other state bonds, such as to build roads and bridges.

Finally, some states have implemented other kinds of programs to help families save for college, different from both tuition prepayment and college savings bond programs. Kentucky's program, for example, allows participants to save money in a special college savings account. People can save as much or as little as they like on behalf of a designated beneficiary, depending on their individual savings goals, and deposits may be as low as $25. The program guarantees a minimum 4-percent rate of return, and the interest earned is exempt from state—though not federal—income taxes. When withdrawn, the funds can be spent at virtually any college in the country. However, a penalty applies if the funds are withdrawn inside of 8 years.

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[6] Because the bonds are intended as a college savings vehicle, they are sometimes referred to as baccalaureate bonds.

[7] To encourage purchasers to use these bonds to pay for college, however, at least one state—Illinois—pays a bonus on redemption if the funds are spent at an institution of higher education.

Federal Proposals and Action on College Savings

As state officials moved to enact college savings programs in the late 1980s, the federal government also responded to concerns about the rising cost of a college education. During the 100th Congress (1987-88), the Senate Committee on Finance held a hearing on ways to encourage saving for college, and numerous college-savings proposals were introduced in the Congress. These proposals, typically involving preferential tax treatment, included a wide variety of approaches to encourage college savings:

- Some proposals called for the establishment of a national education savings trust, similar to a state tuition prepayment program. Individuals would have been able to buy contracts covering a certain amount of future college expenses at any college in the country. Participants would have received various tax advantages, such as (1) a deduction for cash payments to the program and (2) an income exclusion for the funds paid out by the program to a college. In addition, the trust itself would have been designated as a tax-exempt entity, free from federal, state, and local taxes.
- Another proposal would have created federal tuition savings certificates that could either be redeemed for cash or turned over to a college as payment for tuition. Colleges that accepted the certificates and kept tuition increases under a certain level would have received a bonus based on all the certificates they redeemed. Taxes on the interest earned from the certificates might have been deferred and possibly assessed at the student's tax rate.
- Still other proposals would have created special savings accounts for education featuring various tax advantages, such as a tax credit for contributions or a tax exclusion on the interest used to pay for higher education.

The 100th Congress did pass one major college-savings proposal. With the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647), the Congress created a federal income tax advantage for using series EE savings bonds to pay for certain higher education expenses. For savings bonds purchased in 1990 or later, taxpayers may deduct from their gross income the interest earned on bonds used to pay for tuition and required fees at accredited colleges and universities. However, there is a phase-out structure for the exclusion, designed to favor lower- and middle-income families: Taxpayers below a certain income level may qualify for a full exclusion; those between the lower and upper income limits for a partial exclusion, decreasing as their income rises; and those above the upper limit do not qualify for any exclusion. For 1994, the lower and upper income limits were $41,200 and $56,200 for single filers, and $61,850 and $91,850 for joint filers.[8]

Passage of the higher education provision for U.S. savings bonds, however, did not quell lawmakers' concerns about the ability of American families to pay for college. In subsequent years, Members of Congress continued to introduce college savings legislation. Over 20 bills addressing tax advantages for college savings were introduced in the 101st Congress, for example, but none was enacted. Twice during the 102nd Congress, both houses of the Congress passed legislation that, among other things, would have allowed penalty-free withdrawals from individual retirement accounts (IRA) to pay for higher education expenses, but both bills were vetoed by the President. Similar proposals were introduced in the 103rd Congress, but did not pass.

Several more college-savings proposals have been introduced in the 104th Congress. One approach, proposed in two of the bills, would allow taxpayers to establish special savings accounts, similar to IRAS. Contributions to these accounts would be made with after-tax dollars, but distributions used to pay certain higher education expenses would be deductible from the taxpayer's gross income.

Private Sector College Savings Plans

The private sector also responded to the growing interest in saving for college. Insurance companies, investment firms, and financial planners offer a range of services to help parents meet their college savings goals. One notable private sector initiative is the College Savings Bank of Princeton, New Jersey, which issues a certificate of deposit (CD) indexed to annual increases in private college costs and guaranteed to cover tuition, fees, and room and board in the future, no matter how high those costs rise. Participants decide how much and how often to save. The CDS are available in maturities from 1 to 25 years. The minimum initial deposit is $1,000 and subsequent deposits must be at least $250.

Objectives, Scope, and Methodology

Because of their interest in helping families to save for college expenses, the Chairman of the Senate Committee on Labor and Human Resources; the Chairman of the Subcommittee on Education, Arts, and the Humanities; and Senator Thad Cochran asked us to report on state tuition prepayment programs. In response, we agreed to (1) describe how these programs operate and the participation rates they have achieved, (2) assess participants' income levels and options for increasing the participation of lower-income families, and (3) discuss the major issues concerning these programs.

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[8] For more information on the rules pertaining to the savings bond income exclusion, see Education Savings Bonds: Eligibility for Tax Exclusion, Report No. 89-570 EPW, Congressional Research Service, Library of Congress (Oct. 16, 1989). For information on the extent to which people have claimed the exclusion thus far, see College Savings Issues (GAO/HEHS-95-16R, Nov. 4, 1994).

To meet these objectives we

- reviewed available literature on these programs, state reports assessing various college saving programs, and brochures and other documents produced by, or pertaining to, tuition prepayment programs;
- interviewed key program officials in all seven of the states that were operating tuition prepayment programs during the time of our study, financial aid officials in several participating colleges, federal officials in the Department of Education and the Internal Revenue Service (IRS), and other experts; and
- obtained income data on program participants from state officials, which we compared with similar data on other state residents from the Bureau of the Census, including the decennial census and the Current Population Survey.[9]

We conducted our study from June 1993 to May 1995 in accordance with generally accepted government auditing standards.

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[9] Further details on our data and analytical methods are presented in ch. 3.

Tuition Prepayment Program Operations and Participation Levels

Although existing state tuition prepayment programs operate similarly, they all have unique features that distinguish them from one another. Until recently, these programs have followed one of two models for how they package and sell prepaid benefits, but Massachusetts has now introduced a third model. Analyzing program participation rates, we found considerable variation between states. When asked what factors are important for achieving a high level of participation, program officials emphasized effective advertising and marketing efforts, a positive public perception, affordability, and the simplicity and flexibility of the program. We also found that participation rates are generally higher in states where tuition is more affordable to the average family.

Similarities and Differences Between State Tuition Prepayment Programs

Existing state tuition prepayment programs share certain basic similarities in terms of how they operate. A purchaser may be the beneficiary's parent, grandparent, other relative, or friend, and in some cases, even businesses and charitable organizations can purchase tuition benefits on behalf of a designated beneficiary. In most programs, either the purchaser or the beneficiary must be a resident of the state to join the program. Also, most states require beneficiaries to be below a certain age or grade level.

The programs charge roughly current prices for tuition and other educational benefits at in-state public colleges; however, in some cases a premium may be charged and in others a discount may be offered, especially for younger children who are many years away from enrolling in college. The prices are adjusted annually to reflect increases in college costs. Purchasers can pay for the desired benefits either all at once with a lump-sum payment or with a series of payments over time. To make purchasing the benefits as easy as possible, some programs offer the option of payroll deductions or electronic fund transfers. To join the program, would-be purchasers also generally must pay a nonrefundable application fee. In some states, the program enrollment period is limited; in others, enrollment is year-round.

In a sense, the programs operate like pension plans—they invest money now to meet an estimated future liability. The revenues from purchasers' payments are pooled in one large fund and invested with the goal of achieving a higher rate of return than the rate at which tuition and other prepaid expenses increase. Indeed, beating the tuition inflation rate is more than just a goal, it is imperative for programs to succeed. However, in case the fund becomes actuarially unsound, most states have built in an escape clause that would allow them to end the program and issue refunds to the participants.

Each semester that the beneficiary enrolls in a participating college, the program pays to the school whatever amount it currently charges for tuition and fees and any other prepaid benefits, such as housing expenses. Beneficiaries who are not state residents when they enroll in a participating college may be required to make up the difference between in-state and out-of-state tuition rates. Typically, the benefits can be used for several years after the beneficiary reaches college age.

Various refund provisions apply if the beneficiary cannot use the benefits due to death or disability; chooses not to go to college at all; or decides to attend a nonparticipating college, such as a private college or an out-of-state public college. (The programs do not guarantee that the beneficiary will be accepted for enrollment at one of the participating colleges.) Under certain circumstances, the programs allow a new beneficiary to be named in place of the original one; however, prepaid benefits may not be sold or traded.

Despite the overall similarities between state tuition prepayment programs, each state's program is unique in its details, with different costs, rules, and other program features. Table 2.1 presents an overview of the seven programs we studied.

Table 2.1: State-by-State Comparison of Tuition Prepayment Programs

	Alabama	Alaska	Florida	Michigan	Ohio	Pennsylvania	Wyoming
When did the program start?	Summer 1989	Spring 1991	Fall 1988	Fall 1988	Winter 1989	Fall 1993	Summer 1987
What does a purchaser buy?	Contract	Tuition credits	Contract	Contract	Tuition credits	Tuition credits	Contract
What is the cost of a lump-sum payment for 4 years of tuition and fees at a state college?	In 1993: $7,961 for an 8th grader, $4,892 for an infant	As of fall 1993: $7,920	As of fall 1993: $5,879 for an 11th grader, $5,639 for a newborn	As of fall 1990: $15,496 for a 12th grader, $8,380 for a newborn	In 1994: $15,000	As of fall 1993: $12,057 for state system schools, $21,918 for state-related schools	As of fall 1993: $28,182 for a 4th grader, $14,462 for a newborn
What additional types of benefits can a purchaser buy?	None	None	Housing	None	None	None	Room and board
How many institutions participate in the program?	15 4-year institutions and 35 community colleges[a]	1 4-year institution (3 campuses) and 1 community college	9 4-year institutions and 28 community colleges	15 4-year institutions and 29 community colleges	13 4-year institutions and 23 community colleges	18 4-year institutions and 14 community colleges	1 4-year institution and 7 community colleges
Is there a residency requirement for either the purchaser or the beneficiary?	Yes	No	Yes	Yes	Yes	Yes	No
Can a beneficiary move to another state and still qualify for resident rate when using benefits at time of enrollment?	No	Yes	Yes	No	Varies by school	No	Varies by school
When can people join program?	May 1-31	Year-round	Mid-October - mid-January	Before contract sales were halted in 1991, enrollment took place in the fall	Year-round	Year-round	Year-round
Does the program offer monthly payment contracts?	Yes	[b]	Yes	Yes	[b]	[b]	No

(continued)

	Alabama	Alaska	Florida	Michigan	Ohio	Pennsylvania	Wyoming
What is the minimum amount of benefits that can be purchased?	Contract for 4 years of tuition and fees	6 tuition credits initially and subsequent purchases of 1 credit	Contract for 2 years of tuition at a community college	Contract for 1 year of tuition and fees	1 credit	1 tuition unit (1/20 of a tuition credit)	Contract for 1 year of tuition and fees
What is the maximum amount of benefits per beneficiary?	4 years	b	4 years of tuition and fees; 5 years of dormitory space	4 years	400 credits	b	4 years
Can a purchaser or beneficiary get a refund with interest in case of							
—death or disability of the beneficiary?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
—voluntary withdrawal?	No	No	No	Yes	No	No	Yes
—a decision not to attend college?	No	No	No	Yes	No	No	Yes
Can the value of benefits be used toward cost of attendance at a nonparticipating institution?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Can benefits be transferred to someone else?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
How long after anticipated college enrollment date can benefits be used?	10 years (extensions allowed)	15 years (extensions allowed)	10 years (extensions allowed)	9 years	No stipulation on when benefits can be used	15 years (extensions allowed)	6 years
How much is the application fee?	$75	$40	$42	$25, plus a $60 processing fee	$50	$65	None
Are there any additional fees for							
—failing to make payments on time?	Yes	b	Yes - $10	Yes - $10	b	b	b

(continued)

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	Alabama	Alaska	Florida	Michigan	Ohio	Pennsylvania	Wyoming
—voluntary withdrawal from the program?	Yes	Yes - $50	Yes	Yes - $200	No	Yes - $10	No
—involuntary termination due to failure to use benefits, default, or fraud?	Yes	No	Yes	Yes	Yes - $25	No	No
—beneficiary substitution?	Yes	Yes - $20	Yes - $5	Yes - $25	Yes - $25	Yes - $10	No
—transfer of contract ownership?	Yes	[b]	[b]	[b]	[b]	Yes - $10	No
Are benefits taxed by the state?	No	[b]	[b]	Yes	No	No	[b]
Is the program backed by the full faith and credit of the state?	No	No	Yes	No	Yes	No	No
Will the program honor benefits if the program is terminated?	Yes	Refund	Yes, for beneficiaries within 5 years of college enrollment. Others will receive a refund with interest.	Refund	Refund	Yes	Yes

[a] Although some states also have "junior colleges," "technical colleges," or "senior colleges," we use the term community colleges to represent all public 2-year institutions.

[b] Not applicable.

Two Main Types of Prepayment Programs

Until recently, state tuition prepayment plans have followed one of two basic models in terms of how they package and sell their education benefits. Michigan's tuition prepayment program served as a general model for those adopted later in Wyoming, Florida, and Alabama. Under these states' programs, purchasers sign a contract to buy a predetermined amount and type of tuition benefits. For example, Florida's program offers prepaid tuition contracts for 2 years at a community college, 2 years at a community college plus 2 years at a state university, or 4 years at a state university.[10] Typically, if the purchaser fails to pay for the benefits as agreed, program officials will cancel the contract and issue a refund. Furthermore, in prepayment programs such as these, the price of the benefit packages varies by the age of the beneficiary, with prices highest for those children closest to college age and lowest for newborns/infants.[11] For example, during the 1993-94 enrollment period in Florida, a lump-sum payment for a contract guaranteeing 4 years at a state university was about $5,900 for a child in eleventh grade and about $5,600 for a newborn.[12]

Ohio took a slightly different approach with its tuition prepayment program, which became a general model for those established later in Alaska and Pennsylvania. In these states, purchasers open a prepaid tuition account for a designated beneficiary by making an initial minimum purchase; thereafter, they may buy whatever amount of benefits they desire—typically, up to a cumulative maximum of 4 years—at any time. These programs are sometimes referred to as prepaid tuition credit programs, because they sell tuition benefits by the credit hour, or in even smaller units. Thus far, none of these account-based prepayment programs has offered housing benefits. The prices of tuition benefits for these programs do not vary by the beneficiary's age; rather, all purchasers pay the same price for the same type of benefit.

Massachusetts Program Represents New Prepayment Model

In February 1995, Massachusetts introduced a tuition prepayment plan different from all others. The program sells "tuition certificates" redeemable toward the cost of tuition and fees at any public or private college in the state that agrees to participate in the program; 67 institutions have signed up so far. The certificates are guaranteed to hold their value until redeemed by the beneficiary. For example, if a $1,200 certificate is equal to 20 percent of tuition costs at a given college at the time of purchase, the certificate will cover that same percentage of costs when the beneficiary enrolls at that college in the future. Actually, the program will pay colleges an amount equal to the face value of the certificate plus interest at the rate of 2 percent above the CPI, compounded annually. Thus, the colleges accept the risk that their costs will rise more than the value of the certificates. Because the certificates are based on state bonds, they are exempt from state taxes, and program officials expect they will also be exempt from federal taxes. The minimum purchase is $300 per beneficiary per maturity year.

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[10] Purchasers of a 4-year state university contract in Florida can also prepay the cost of up to 5 years of housing benefits, guaranteeing the beneficiary a space in a university dormitory.

[11] The programs we reviewed used either "newborn" or "infant" to describe the youngest age category.

[12] In Alabama's program the difference between the highest and lowest prices is much greater, reflecting a significant discount for younger children. In 1993, the lump-sum payment for a 4-year contract was $7,961 for an eighth grader and $4,892 for an infant.

Programs Have Achieved Varying Participation Rates

One measure of the success of state tuition prepayment programs is their overall participation level—the total number of contracts purchased or tuition accounts opened. Naturally, a goal of any program like this is to get as many families saving for college as possible. We found that the number of participants in existing state tuition prepayment programs varies considerably, largely due to differences in the state's population and the number of years the program has been in operation. To account for such differences, we calculated the average annual participation rate for each program. We divided the average number of new participants per year by the number of children in the state most likely to become beneficiaries in these programs. We defined this target group as the number of children below the age limit for joining the program and not living in poverty.[13] Our results are shown in table 2.2.

Table 2.2: Participation Statistics for State Tuition Prepayment Programs

State	Total number of participants	Number of enrollment periods	Average number of participants per year	Size of target group	Average annual participation rate (percent)[a]
Alabama	33,379	4	8,345	660,922	1.26
Alaska[b]	9,053	3	3,018	145,963	2.07
Florida	256,339	7	36,620	2,330,317	1.57
Michigan	54,717	3	18,239	2,127,625	0.86
Ohio	31,989	5	6,398	2,169,162	0.29
Pennsylvania	7,713	1	7,713	1,965,049	0.39
Wyoming	693	7	99	70,414	0.14

[a] Typically, the first year of operation yields a much higher number of participants than the following years. Therefore, over time these rates will likely decrease.

[b] Figures for Alaska represent number of contracts, not number of beneficiaries; a given beneficiary may have several contracts.

Sources: Tuition prepayment program officials and U.S. Bureau of the Census.

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[13] For states that do not have an official age limit, we subtracted the number of years beneficiaries must wait to use their benefits from 18, the age at which students typically enroll in college. The age limits we used were, for Alabama, 14; Alaska, 16; Florida, 17; Michigan, 18; Ohio, 16; Pennsylvania, 14; and Wyoming, 10. (In states with prepaid credit programs, however, credits can still be purchased for beneficiaries past the age limits we used.) We excluded poor children because their families are unlikely to join these programs (see ch. 3).

While none of the seven programs has achieved an average annual participation rate that seems very high, quite a bit of variation exists between states. For example, during its first 7 enrollment periods, Florida's program sold an average of about 37,000 tuition contracts per year, equivalent to 1.57 percent of nonpoor children in the eligible age range. In contrast, Wyoming's program has sold an average of fewer than 100 contracts per year, which is 0.14 percent of its target group. Nonetheless, if sustained over several years, even seemingly small average annual participation rates can eventually result in a large number of program participants, as is the case in Florida.

Extent of Participation Also Varies

The average annual participation rate is an imperfect indicator of program participation, because it does not reflect the varying extent to which people are participating. It counts each participant equally, whether he or she has paid for 4 years of tuition benefits or just a few tuition credits; it even includes individuals who joined these programs but later withdrew. Therefore, to give a more complete picture of program participation, we also obtained data on the amount and type of tuition benefits purchased for beneficiaries in each program, and available information on program cancellation rates.

- Alabama features only one benefit plan—a contract covering 4 years of tuition and fees at any public college or university in the state. Officials report a 6-percent cancellation rate.
- In Alaska, as of June 1993, roughly 54 percent of participants had purchased 1 year's worth of tuition credits or less, about 30 percent had bought 1 to 2 years' worth, about 11 percent had bought 2 to 4 years' worth, and about 5 percent had bought more than 4 years' worth.
- In Florida, about 74 percent of participants have purchased a contract covering 4 years at a state university, about 21 percent have bought contracts for 2 years at community college plus 2 years at a state university, and about 5 percent have bought contracts for 2 years at a community college. Of those who have chosen a 4-year state university contract, about 39 percent have also purchased a dormitory contract covering 1 to 5 years of housing costs. Of the roughly 220,000 tuition and dormitory contracts purchased in the first 5 enrollment periods, about 15 percent had been cancelled by September 1993.
- In Michigan, about 96 percent of participants bought the full benefits contract, less than 1 percent bought a limited benefits contract, and about

4 percent bought a community college contract.[14] Very few MET contracts have been cancelled.

- In Ohio, as of January 1995, 72 percent of participants had paid for 1 year's worth of tuition credits or less, 13 percent had bought 1 to 2 years' worth, 6 percent had bought 2 to 4 years' worth, and 9 percent had bought 4 years' worth.
- In Pennsylvania, as of November 1994, about two-thirds of participants had purchased tuition benefits (credits or units) for state related universities, almost one-third had bought benefits for universities in the state system of higher education, and only about 2 percent had bought benefits for community colleges. The average amount of money spent by each participant was $2,700.
- In Wyoming, 91 percent of participants have purchased contracts covering 4 years at the University of Wyoming, 4 percent have contracts for 1 to 3 years at the University, 4 percent have contracts for 2 years at a community college plus 2 years at the University, and 1 percent have 2-year community college contracts. Of all contracts purchased, 94 percent cover room and board in addition to tuition and fees. To date, only three contracts have been canceled.

Several Factors Considered Important for Maximizing Number of Participants

Clearly, program participation rates are not solely dependent on the size of a state's population and the number of years its program has been operating. When asked what factors were important for maximizing the number of participants, program directors emphasized advertising and marketing, the public's perception of the program, program simplicity and flexibility, and affordability.

Developing Effective Advertising and Marketing Strategies

Several officials mentioned the significance of effective advertising campaigns or other marketing strategies; in fact, some ranked advertising or marketing as the single most important factor for maximizing program participation. Programs have adopted a wide range of advertising and marketing strategies to reach out to potential participants. Following are some examples of these efforts.

- Michigan's program mailed packets of information to elementary and secondary schools, advertised on place mats used at a major fast-food chain, and distributed flyers in the largest grocery store chain in the state. Michigan also produced a short, informational videotape about the program that could be borrowed free from video rental stores and public libraries throughout the state.

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[14] The full benefits contract covers tuition and fees at any Michigan public university or community college. The limited benefits contract covers tuition and fees only at Michigan public colleges whose tuition costs do not exceed 105 percent of the weighted average tuition cost of Michigan's 4-year institutions. The community college contract covers tuition and fees at any of Michigan's community colleges.

- Florida's program, which has an annual advertising budget of $500,000, pays for numerous television and radio commercials—in both English and Spanish—during the 3-month enrollment period. Similar to strategies used in Michigan, the program mails packets of brochures to every elementary and secondary school in the state, and it also distributed a videotape to video rental stores throughout the state. "Florida has averaged over 40,000 prepaid contracts each year," wrote the program's Director, "because it has approached consumers rather than expecting them to seek out the program."[15]
- Alabama's program has never paid for commercial advertising, relying instead on public service announcements; when done correctly, the Director said, this method can be quite effective for reaching potential purchasers.
- Alaska's program Director also said paid advertising may not be necessary to reach potential customers. Alaska's primary marketing strategy is to enclose information about the prepayment program in the annual mailing that goes to all state citizens concerning their Permanent Fund dividend.[16]
- Pennsylvania's program also uses the mailing services of another state agency: a brochure on the tuition prepayment program is included in every license renewal notice sent out by the Bureau of Motor Vehicles—over 20,000 per day. Like Michigan and Florida, Pennsylvania also produced a videotape on its program, which officials distributed to about 5,000 schools in the state.
- Ohio's program has done some advertising on television and radio, but found newspaper ads to be the most effective form of paid advertising. The program also does extensive marketing in schools, and officials work at trade shows and youth fairs to promote the program and to give away items like refrigerator magnets and jar openers with the program's logo printed on them. Ohio also does grassroots outreach, such as having program participants volunteer to speak at meetings of various community and civic groups.

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[15] William Montjoy, "State Prepaid Tuition Plans: Designing a Successful Program," Prepaid College Tuition Plans: Promise and Problems, ed. Michael A. Olivas (New York: College Entrance Examination Board, 1993), p. 47.

[16] The Permanent Fund is made up of revenues from oil companies doing business in the state. Every year, a portion of the fund's earnings is distributed, as a dividend, to all state residents. Everyone receives the same amount, regardless of income, age, or other factors.

Officials had differing opinions about the challenge involved in getting people to join a tuition prepayment program. One said it is difficult to get people to save money for anything, let alone their children's college educations, which could be many years away. In contrast, however, one official said that prepaid tuition benefits are naturally appealing, and that once people are aware of the program, it practically sells itself.

Achieving and Maintaining Positive Public Perception

Another factor considered important for achieving a high participation rate is developing a positive public perception of the program. Several officials described the need to build and maintain the public's confidence in the program as a safe, reliable way to provide for children's college educations.

One way to develop a positive image, some officials said, is through the involvement of a well-known, high-profile supporter, someone who can attract the public's attention and stir up interest in the program. In some states this role has been played by the state treasurer. Another key is getting positive coverage by the news media; for example, several officials mentioned the importance of favorable newspaper stories and editorials about the program.

The fact that these programs are affiliated with the state government or the state university, a few officials said, may also help some participants to have confidence in the program. That is, people could be more trusting and feel more comfortable dealing with public officials than with private investment advisors. However, being a state-sponsored program can cut both ways, one official said, because some people strongly distrust government and would not voluntarily give their money to the state for any purpose. Furthermore, although these programs are connected with the state, some officials stressed the importance of trying to remain nonpartisan in a political environment. "If the public's impression is that the program has become politicized," wrote Florida's Director, "confidence will be lost and sales will plummet."[17]

The connection between public perception and sales levels is clear to Ohio's program Director. She said public confidence in the state's program was shaken somewhat last year when state newspapers widely reported that the Governor had questioned whether the program was a good deal for participants. As the Governor's office, the legislature, and program officials decided what to do about the program, the number of new participants dropped to less than 2,000 in 1994, after averaging over 5,300 in the preceding 3 years. The issues in question have been resolved, according to the Director—the program is now a better deal than ever, she said, with lower prices and backed by the full faith and credit of the state—but now officials must rebuild a positive public perception of the program to increase sales to their previous level.

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[17] Montjoy, "State Prepaid Tuition Plans," p. 48.

Creating a Simple, Flexible Program

Two additional factors that officials described as important for achieving a high participation level were program simplicity and flexibility. In terms of simplicity, one official explained that typical participants in these programs do not have experience with complex, sophisticated investment vehicles; they are looking for a program that is easy to understand. Some officials described coupon books as a simple way for purchasers to make payments. Here is how Florida's program Director addressed this general issue: "In marketing a prepaid program, every effort should be made to keep it simple. One of the primary elements of success is providing a plan that the public can easily understand and use. Facilitating applications, without imposing numerous rules and guidelines, is critical to contract sales volume."[18]

In addition to being simple, some officials said, tuition prepayment programs must also be flexible. They need to offer purchasers and beneficiaries a range of choices, such as different types of benefit plans and payment options. These programs should also not prohibit early withdrawals, according to one official; purchasers should be able to get back at least their principal if needed. Flexible features are often emphasized in program literature. For example, Pennsylvania's program brochure describes how purchasers can buy credits at any time, in any amount desired, and that students can use their benefits toward the cost of any accredited college in the country. Florida's brochure mentions the ability to convert from one benefit plan to another, and that students can use their benefits while attending college part time over more than 4 years.

The notion that program flexibility is associated with participation levels is supported by anecdotal evidence from Florida. In the spring of 1993 the program changed its rules to allow beneficiaries to use the full value of their benefits toward attendance at out-of-state colleges; prior to then, they could receive the principal but no interest. While the number of tuition contracts sold the previous 3 years averaged about 30,000, during the 1993-94 enrollment period, sales jumped to about 44,000.

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[18] Montjoy, "State Prepaid Tuition Plans," p. 47.

Making Program Affordable

A few officials stressed program affordability as another key to achieving a high level of participation. Alabama and Michigan tried to make their programs more affordable by offering substantial discounts on contracts for younger children. Ohio and Pennsylvania sell tuition benefits in small units, rather than multiyear contracts that might seem prohibitively expensive, given the relatively high cost of tuition in those states. In addition to making the prepaid benefits affordable, another official mentioned the importance of keeping program fees at a reasonable level, so as not to impose a financial burden on participants. Initial fees for the programs we reviewed ranged from none in Wyoming to $75 in Alabama.

Affordability, of course, is also a function of people's incomes. In deciding whether to participate in these programs, one official explained, potential purchasers ask themselves if the payments will fit into their monthly budgets. When people find it difficult to make ends meet or are worried about their job security, they are less likely to make a significant financial commitment to these programs, and those who are already participating may decide to cancel their contracts or stop purchasing credits. For example, a couple of officials reported that the recession in the early 1990s hurt program sales.

Participation Levels Linked to College Affordability

In general, program participation is higher in states where tuition is more affordable. To measure affordability for each state, we first obtained Department of Education data on the average cost of 1 year of tuition and fees at 4-year public colleges during each year the program has been in operation. Second, we used data from the Census Bureau's Current Population Survey (CPS) for the same years to determine the annual median family income for all families with children under age 18. Finally, we divided the tuition cost by the median income, and averaged the percentages over the years the program has been operating. We then compared each program's affordability measure with its average annual participation rate, described above. As table 2.3 shows, with the exception of Wyoming (which has had the most affordable tuition rates and the lowest participation rate), as tuition accounts for a smaller percentage of median family income, participation generally rises. This analysis suggests that tuition prepayment programs will be more successful in states where tuition is relatively more affordable to the average family.

Table 2.3: Participation Generally Higher in States Where Tuition Is More Affordable

Numbers in percent

State	Percentage of family income needed to cover tuition and fees[a]	Average annual participation rate
Wyoming	3.19	0.14
Alaska	3.84	2.07
Florida	4.37	1.57
Alabama	5.28	1.26
Michigan	6.27	0.86
Ohio	7.30	0.29
Pennsylvania	9.57	0.39

[a] Average percentage of median family income needed to cover the cost of 1 year's tuition and fees for a state resident at 4-year public colleges and universities during the years the program has been selling prepaid benefits.

Income Distribution of Participants and Options for Increasing Lower-Income Participation

By comparing the income distribution of program participants to that of other families living in tuition prepayment states, we found that participants come disproportionately from middle- and upper-income families. However, officials saw drawbacks to the use of sliding-scale fees and tax credits, and were not optimistic about the chances of significantly increasing lower-income participation in their programs. Most of these states have explored ways to give prepaid tuition scholarships to needy students, although these efforts generally have not been very successful. Despite efforts to make prepaid benefits affordable to all families, a significant increase in lower-income participation is unlikely, given that such families lack discretionary income; unable to save substantially for college, such families will have to rely more on various financial aid programs.

Most Participants Come From Middle- and Upper-Income Families

Participants in tuition prepayment programs mainly come from middle- and upper-income families. For example, in each of the three states with the best available income data on participants—Florida, Alabama, and Ohio—most families with children under 18 had annual incomes of under $30,000 in 1992, while most purchasers reported incomes of $50,000 and above. For the other four states, which did not have direct measures of participant income, our analysis generally indicated that a disproportionate percentage of program participants live in zip codes with relatively high median incomes.

Income Analysis and Results for Florida, Alabama, and Ohio

Officials in Florida, Alabama, and Ohio were able to provide us with self-reported income data on program participants. For both Florida and Alabama, the program application contains an optional question for purchasers to indicate their family income level in one of several categories, such as less than $20,000, $20,000-$29,999, $30,000-$39,999, $40,000-$49,999, and $50,000 or more. Both states provided us with these data for several enrollment years. We compared the income distribution of program participants in these two states with that of all state families with children under 18, using CPS data.

For Florida, we limited our analysis to include only purchasers who were parents of beneficiaries under age 18 at the time of enrollment. This provided the best possible comparison with the families represented by the CPS data. The response rate to the optional income question among this group of purchasers was about 63 percent. However, after comparing the payment plans and contract types chosen by respondents and nonrespondents, we have no reason to believe their income distributions differ substantively.

For Alabama, our analysis of program application data included all purchasers with beneficiaries under 18, regardless of their relationship to the beneficiary. Although program officials did not provide specific numbers, they said the vast majority of purchasers are parents of the designated beneficiaries. The response rate to the optional income question was about 72 percent. Alabama also provided us with state income tax data on over 25,000 program purchasers, representing 93 percent of all active purchasers as of fall 1994.[19] We compared purchasers' total income from their 1992 or 1993 state tax return (whichever was the most recent available) with the same CPS data used in the preceding analysis.

Ohio's tuition prepayment program does not routinely collect income data on its participants. The income data we present come from a 1992 market study conducted for the program by a private consulting firm.[20] The study used telephone interviews of 200 purchasers and 400 nonparticipants in the state with children or grandchildren aged 14 and under. We adjusted the percentages reported in the study to reflect only respondents who answered the income question, which included about 85 percent of each group.

In Florida, most program participants come from middle- and upper-income families. Over one-half of the 1992-93 purchasers in our analysis reported incomes of $50,000 or more, compared with about one-quarter of all Florida families. In addition, only 5 percent of the participating parents had incomes of less than $20,000, compared with 36 percent of all families in the state. (See fig. 3.1.) The data for other years we examined yielded very similar results.

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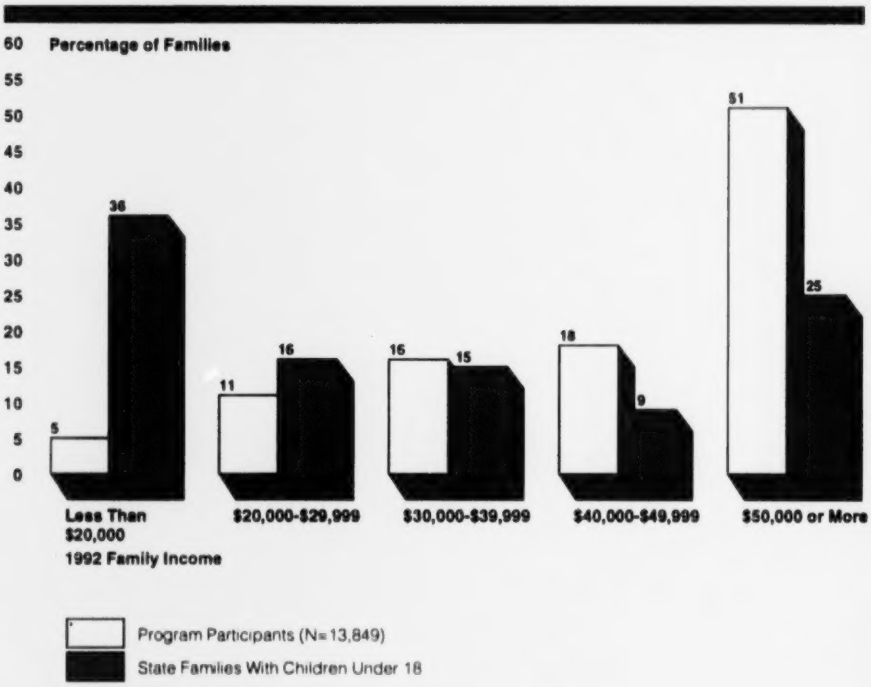
[19] The tax data provided by the Alabama Department of Revenue did not include individuals' names, social security numbers, or any other personal identifiers. Active purchasers includes all those who are either paid in full or continuing to make payments on their contracts.

[20] OTTA Market Survey Report, Clark Jones Inc. (Columbus, Ohio: Aug. 1992).

Figure 3.1: Income Levels of Families Participating in Florida's Program, Compared With All Families in the State

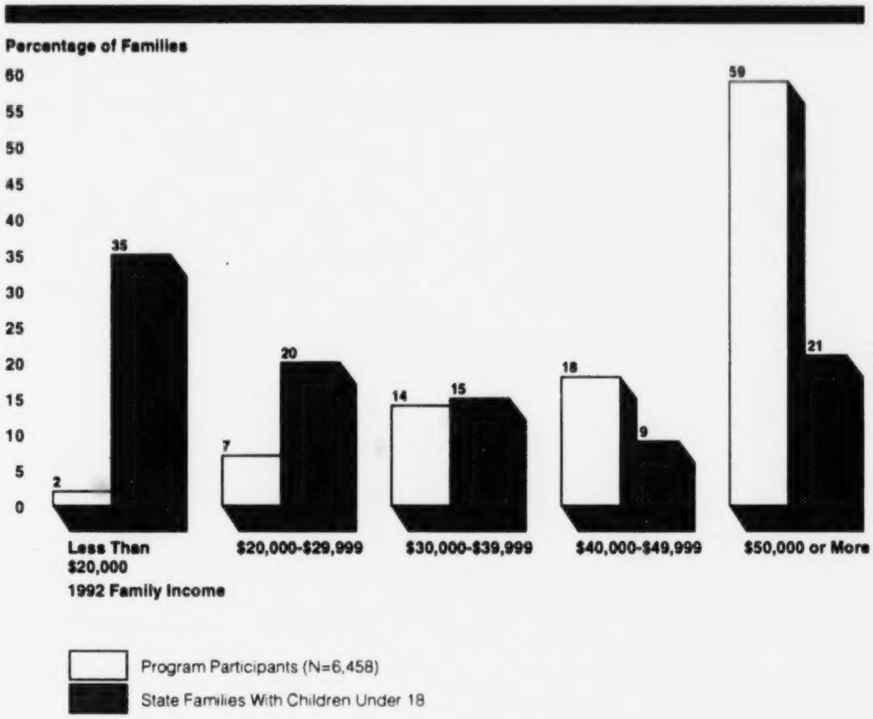


Note: Percentages may not add to 100 because of rounding. Sampling errors for CPS estimates do not exceed plus or minus 3 percentage points.

Sources: Florida program officials and Bureau of the Census' 1993 Current Population Survey.

The results for Alabama were very similar to Florida's. About 60 percent of all 1992 purchasers in our analysis reported incomes of $50,000 or more, compared with about 20 percent of all families in the state. At the lower end of the scale, only 2 percent of the purchasers reported incomes of less than $20,000, compared with about 35 percent of all Alabama families. (See fig. 3.2.) In other years, the results were comparable. The Alabama tax return data produced results similar to the program application data. For example, only 8 percent of purchasers had 1992 or 1993 incomes of less than $20,000 and 66 percent had incomes of $50,000 and above. Furthermore, the median income for purchasers was about $61,000, compared with about $27,400 for all families in the state.

Figure 3.2: Income Levels of Families Participating in Alabama's Program, Compared With All Families in the State

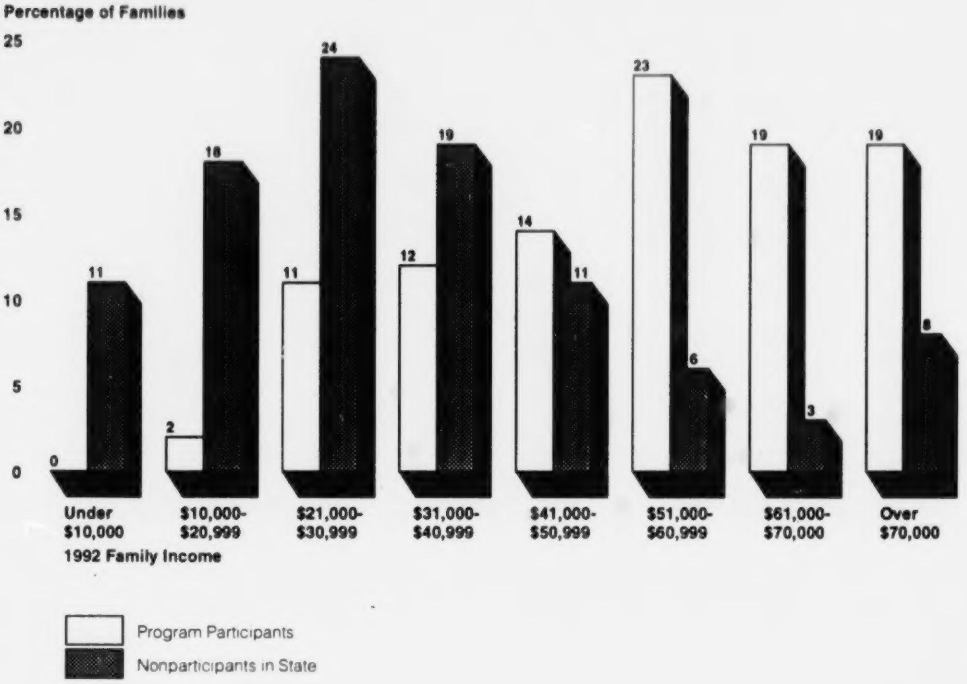


Note: Sampling errors for CPS estimates do not exceed plus or minus 6 percentage points.

Sources: Alabama program officials and Bureau of the Census' 1993 Current Population Survey.

The income distributions of participants and other families in Ohio are similar to those in Alabama and Florida. About 60 percent of purchasers reported incomes of $51,000 or above in 1992, compared with less than 20 percent of nonparticipating families. In addition, only 2 percent of the purchasers had incomes of less than $21,000, compared with about 30 percent of nonparticipants. (See fig. 3.3.)

Figure 3.3: Income Levels of Participants in Ohio's Program, Compared With Nonparticipants in the State



Note: Percentages based on responses by approximately 170 participants and 328 nonparticipants with a child or grandchild aged 14 or under.

Source: Ohio Tuition Trust Authority Market Survey.

Income Analysis and Results for Remaining States

The four remaining states—Alaska, Michigan, Pennsylvania, and Wyoming—do not collect income data on their purchasers, but they did have a record of each purchaser's zip code, which we used as a rough proxy for income. First, we used 1990 Decennial Census data to determine the median household income and the total number of residents under age 18 for every zip code in each state. Next, we assigned the median household income of each zip code to each child living in that zip code. Then we divided the number of children in each state into quartiles on the basis of their assigned income. Finally, we determined the percentage of program purchasers living in each of the income quartiles. If there were no relationship between income and program participation, we would expect to find about 25 percent of purchasers living in each quartile. Our findings are shown in table 3.1.

Table 3.1: Income Distribution of Purchasers in Alaska, Michigan, Pennsylvania, and Wyoming

	Alaska (N=7,290)[a]		Michigan (N=47,935)		Pennsylvania (N=5,611)		Wyoming (N=450)	
Income quartile	**Income range**	**Percentage of purchasers in quartile**	**Income range**	**Percentage of purchasers in quartile**	**Income range**	**Percentage of purchasers in quartile**	**Income range**	**Percentage of purchasers in quartile**
Lowest	$33,801 and under	20	$24,364 and under	7	$22,802 and under	13	$22,955 and under	29
Second lowest	$33,802 - $42,868	26	$24,365 - $30,658	16	$22,803 - $28,333	22	$22,956 - $26,250	27
Second highest	$42,869 - $47,472	27	$30,659 - $38,382	23	$28,334 - $35,230	27	$26,251 - $33,427	25
Highest	More than $47,472	28	More than $38,282	54	More than $35,230	38	More than $33,427	19
Total[b]		**100**		**100**		**100**		**100**

[a] Figures represent number of contracts; not number of beneficiaries; a given beneficiary may have several contracts.

[b] Totals may not add to 100 because of rounding.

In Alaska's program, purchasers were almost evenly distributed among the four income groups, with a slightly lower percentage living in the lowest-income quartile. About 28 percent of purchasers lived in the zip codes that made up the highest-income quartile, with median incomes over $47,472, and about 20 percent lived in the zip codes composing the lowest-income quartile, with median incomes of $33,801 or less.

In Michigan, the distribution of purchasers was more skewed toward the higher-income quartiles than in the other three states. Over half of the purchasers were from the zip codes included in the highest-income quartile, with median incomes of $38,282 and above. In contrast, purchasers residing in the zip codes composing the lowest-income quartile, with median incomes of less than $24,364, represented only about 7 percent of all purchasers.[21]

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[21] Following a similar methodology, another researcher previously found similar results for Michigan participants, showing 50 percent of the beneficiaries residing in the richest quintile of state zip codes, compared with only 4 percent living in the poorest quintile. See Jeffrey S. Lehman, "Social Responsibility, Actuarial Assumptions, and Wealth Redistribution: Lessons About Public Policy From a Prepaid Tuition Program," Michigan Law Review, Vol. 88 (Apr. 1990), pp. 1035-1141 (see especially app. 1, pp. 1134-1141).

In Pennsylvania, people from the higher-income zip codes accounted for a somewhat disproportionate share of program participants. About 38 percent of purchasers were living in the zip codes that constituted the highest-income quartile, with median incomes over $35,230. In contrast, about 13 percent of purchasers were living in the zip codes composing the lowest-income quartile, with median incomes of $22,802 or less.

In Wyoming, the distribution of purchasers was reversed from what we found in the other three states. Although purchasers were almost evenly distributed among the four income groups, slightly more lived in the lower-income quartiles than in the higher-income quartiles. About 19 percent of the purchasers lived in the zip codes composing the highest-income quartile, with median incomes of $33,427 and above, while about 29 percent lived in the zip codes that made up the lowest-income quartile, with median incomes of $22,955 or less. We are not sure what factors might account for this finding.

Variable Fees, Tax Credits Considered Poor Options for Increasing Lower-Income Participation

Program directors believed that using sliding-scale fees and offering tax credits would have drawbacks as options for increasing participation among lower-income families; specifically, they expressed concerns about administrative feasibility and effectiveness. Although other options could be developed, we asked officials for their opinions on these two options because they were mentioned in the literature.

Sliding-Scale Fees

Officials did not respond favorably to the idea of implementing a sliding-scale fee system, in which upper-income purchasers would pay more for tuition benefits and lower-income purchasers would pay less. Their primary objection was that such a system would pose substantial administrative problems. It would require them to verify purchasers' incomes, which would be very labor-intensive and especially difficult with limited staff resources. Officials might also have to set up an appeals process, one director said, which would make the programs seem too bureaucratic. Another official said programs might need to obtain special legal authority to verify purchasers' incomes by checking state tax records, because of confidentiality concerns. Finally, a few officials also said a sliding-scale fee system would make it more difficult to make sound actuarial assumptions, because of less certainty about expected revenues.

Besides voicing concerns about administrative feasibility, some officials offered additional reasons why they thought a sliding-scale fee structure might not succeed. For example, two program directors said the concept of charging different prices on the basis of income would be unappealing to many program participants. Applying an income test, one said, would make tuition prepayment seem more like a "social program" and less like an individual savings program. People with above-average incomes would feel penalized, as though they were being required to subsidize others, when all they wanted to do was to help their own children. The program is more appealing, the other director said, when all participants are treated the same.

Another program director had concerns about the fairness of a sliding-scale fee structure. Would it be fair, he asked, to charge variable prices for people who prepay the cost of tuition, based on their incomes, while people who wait to pay for tuition when their children enter college would all face the same rate, regardless of their income? The same official also pointed out that family income can change over time, sometimes dramatically, which could result in some families having prepurchased tuition at a rate that does not reflect their income level when their child is ready for college.

Tax Credits

Compared with their reactions to the idea of sliding-scale fees, officials were somewhat more favorable toward the concept of offering a state or federal tax credit to lower-income purchasers. A few directors thought the idea might succeed in increasing the participation rate among lower-income families. In addition, one official pointed out that because his state does not have an income tax, the tax credit would have to be offered by the federal government; presumably, he said, this would mean fewer administrative headaches for state program officials.[22]

Some officials, however, doubted whether a tax credit would appreciably increase the participation of lower-income families. The problem with a tax credit, two officials said, is that it would not benefit lower-income families until they filed their tax returns; in other words, such families would still find it financially difficult to join the program and make payments in the initial months. Two officials also thought the idea might not succeed because potential purchasers might not fully understand how a tax credit works. Another official said that although the concept has some appeal, it might meet with political opposition. For example, the higher education community might object out of a concern that legislators would make up for the forgone tax revenues by reducing state expenditures on higher education.

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[22] Three of the states with tuition prepayment programs—Alaska, Florida, and Wyoming—do not have a state income tax.

Indirect Efforts to Attract Lower-Income Purchasers

Rather than taking any special steps specifically intended to increase lower-income participation, such as targeted advertising, program officials have mainly tried to attract lower-income families by making prepaid benefits affordable to all state residents.[23] Some officials said that their programs had been designed from the beginning to make it possible for lower-income families to participate, through features such as low-priced benefits and long-term payment plans. Emphasizing these features in brochures and advertisements is the primary way some state tuition prepayment programs try to appeal to lower-income families. Following are some examples of these features in the programs we studied.

- In Pennsylvania, program designers broke down tuition benefits into "units," equivalent to one-twentieth of a credit hour, specifically so that lower-income families could more easily afford the program. During the program's first year of operation, the average cost of one tuition unit for community colleges was only about $3.00. Pennsylvania's state Treasurer stated that the program offers "even the most financially strapped families a mechanism to provide for their children's higher education."[24]
- Wyoming and Michigan both worked with financial institutions to create special loan programs enabling people to borrow the money needed to purchase a contract, even though they might not have had the kind of collateral that would be required for many traditional loans. With these "secured" loans, the prepaid contract itself served as collateral, to be held by the program until the loan was repaid. Also, in its third year of sales, Michigan added monthly payment plan options that allowed contract purchasers to spread out their payments over periods of up to 10 years.[25]

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[23] Interestingly, however, two officials mentioned a goal of increasing minority participation. To the extent that minorities have lower incomes than whites, efforts to increase minority participation could also increase lower-income participation.

[24] Catherine Baker Knoll (remarks prepared for the Third Annual Conference of the College Savings Plans Network, New Orleans, July 8-9, 1994).

[25] One study, however, found that the availability of these long-term payment plans did not significantly change the income distribution of participants in Michigan's program. The author conjectures that the monthly payments were simply too high for most lower-income families; the lowest monthly payment for a contract covering four years of tuition was $112. See Jeffrey S. Lehman, "The Distribution of Benefits From Prepaid Tuition Programs: New Empirical Evidence About the Effects of Program Design on Participant Demographics," Prepaid College Tuition Plans: Promise and Problems, ed. Michael A. Olivas (New York: College Entrance Examination Board, 1993), p. 28.

- Florida and Alabama both offer long-term payment options, allowing purchasers to finance a prepaid tuition contract with monthly payments from the time of purchase until the child reaches college age. In addition, Florida offers a 2-year community college contract, which is much less expensive than the 4-year state university contract.[26] In Florida's 1993-94 enrollment period, the parent of a newborn could purchase a community college contract for just $11 per month using the long-term payment plan.
- In Alaska, citizens can have the state automatically direct up to half of their annual Permanent Fund dividend toward the advance purchase of tuition credits. Parents can even arrange for a portion of their dependent children's dividends to go to the tuition prepayment program. In recent years, the dividend has been about $900 per person. The Director believed this unique source of income, and the ease with which it can be used to purchase tuition credits, might give Alaska's program a greater proportion of lower-income families than other states' programs.

Officials have mixed views on the potential impact these kinds of program features might have on lower-income participation levels. On one hand, some officials are not very optimistic about the likelihood of substantially increasing the proportion of lower-income families participating in state tuition prepayment programs. These programs are intended primarily to help middle-income families, they said, and most lower-income families simply lack the discretionary income to save for their children's college educations. One director even expressed concern that it would be wrong to encourage lower-income families to sign up for a program that might require too great a financial sacrifice.

On the other hand, some officials believe that although it may not be possible for many lower-income families to prepay the cost of 4 full years of tuition at a state university, certain features—especially selling benefits in small units—can help make it possible for some lower-income families to participate in the programs to a lesser degree. From this perspective, even paying for one semester of tuition in advance would be a good thing for these families to do, because it could help get their children thinking ahead about college, looking forward to it as part of their future.

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[26] Depending on the child's age and the payment plan chosen, a community college contract is only about one-third to one-quarter of the cost of a university contract. Furthermore, the community college contract has been much more popular among lower- than upper-income participants. During the program's first 5 years, about 13 percent of purchasers with incomes under $20,000 signed up for a community college contract, compared with less than 2 percent of those with incomes over $50,000.

Direct Outreach to Lower-Income Families

Recognizing that many lower-income families will have difficulty purchasing tuition benefits for their children, but believing that ownership of such benefits will have a positive impact on these children's educational experiences, some states have tried other ways to get prepaid tuition benefits into the hands of needy children—for example, by awarding prepaid tuition scholarships. However, some of these initiatives, described in the following paragraphs, have not yet lived up to their potential.

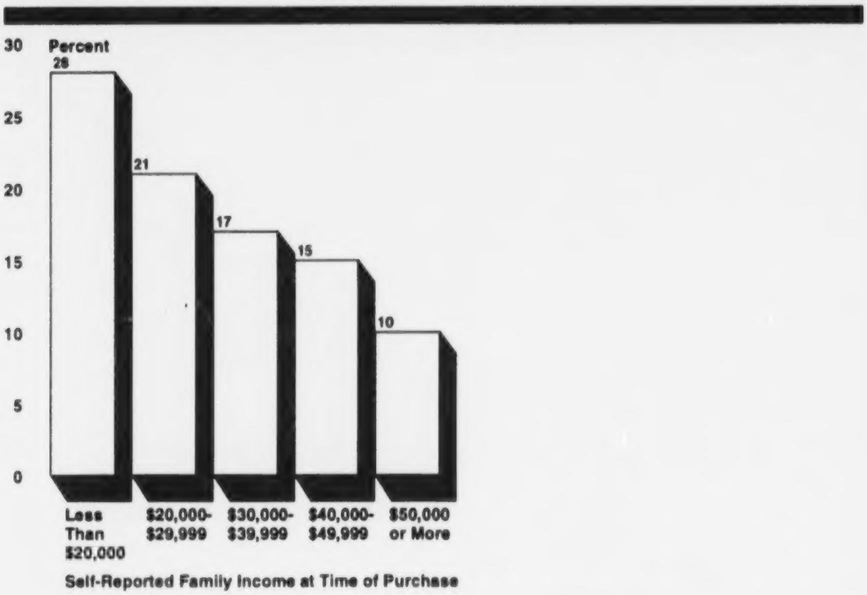
- Florida established a program to give prepaid tuition scholarships to low-income and at-risk students who might not otherwise be able to afford a college education. The program was initially funded by a $1.2 million state appropriation and an equal amount in matching funds raised from private contributions. Thus far, the program has succeeded in awarding scholarships to about 1,000 children throughout the state.
- Michigan also established a prepaid scholarship program, which received a state appropriation of $100,000 in 1991. After officials raised an equal amount in matching funds, they were able to award scholarships to 10 students who had qualified for state-based financial aid but did not receive any because the funds had been depleted. The state appropriated another $50,000 for the scholarship program in 1993, but the money was contingent on 3:1 matching funds, which officials were unable to raise.
- Alaska also created a program to provide prepaid tuition scholarships for needy students, paid for out of excess funds generated by the tuition prepayment program. Unfortunately, however, the prepayment program has not been able to achieve a surplus.
- Alabama established a prepaid scholarship program similar to Florida's, but officials have not had the resources to get it up and running. In addition, the Office of the State Treasurer worked out an agreement with a bank whereby a small percentage of the profits from a certain credit card would go toward prepaid scholarships for foster children. But until now, other cards have offered lower initial interest rates and, in marketing the card, it has been difficult to target consumers with an affinity for the groups who stand to benefit from the profits. Thus, with relatively few people using the card, very little money has been accumulated toward prepaid scholarships.

Increasing Participation Among Lower-Income Families Will Be Difficult

Notwithstanding some of the efforts to make program participation affordable to families from all income levels, it may be unrealistic to expect significantly higher participation rates among lower-income families. Tuition prepayment programs—and other college savings programs as well—are primarily intended to help middle-income families; those who have the ability to save, who will probably be expected to pay for a significant portion of future college costs, and whose children will likely not qualify for need-based grant aid. However, the federal and state governments operate various financial aid programs to assist lower-income families in financing a college education.

In addition, lower-income participants appear to have more trouble than others in meeting the financial commitment inherent in some tuition prepayment programs, especially those that sell contracts with fixed payment schedules. Our analysis of Florida's program found that the lower the purchaser's income, the less likely he or she is to fulfill the terms of the contract (see fig. 3.4). Of all the people who signed up to purchase tuition contracts in the first five enrollment periods (through January 1993), about 28 percent of those with incomes under $20,000 had cancelled out of the program by September 1993. In contrast, for purchasers with incomes over $50,000, the cumulative cancellation rate was only about 10 percent.

Figure 3.4: Cancellation Rates for Tuition Contracts Purchased From Florida's Prepayment Program, by Income Level



Source: Florida program officials

Nonetheless, when it comes to attracting families with modest incomes, tuition prepayment programs may do at least as well as, if not better than, many other college savings options in both the public and private sectors. For example, limited data on the income levels of participants in three states' college savings bond programs show that lower-income families are significantly underrepresented, and upper-income families overrepresented (see fig. 3.5). In Texas, for example, only about 2 percent of 1991 bond purchasers had household incomes less than $25,000, compared with about 39 percent of state households with children under age 18; in contrast, about 41 percent of purchasers had incomes over $65,000, compared with 15 percent of state households with children. We found similar results for both Connecticut and New Hampshire.[27]

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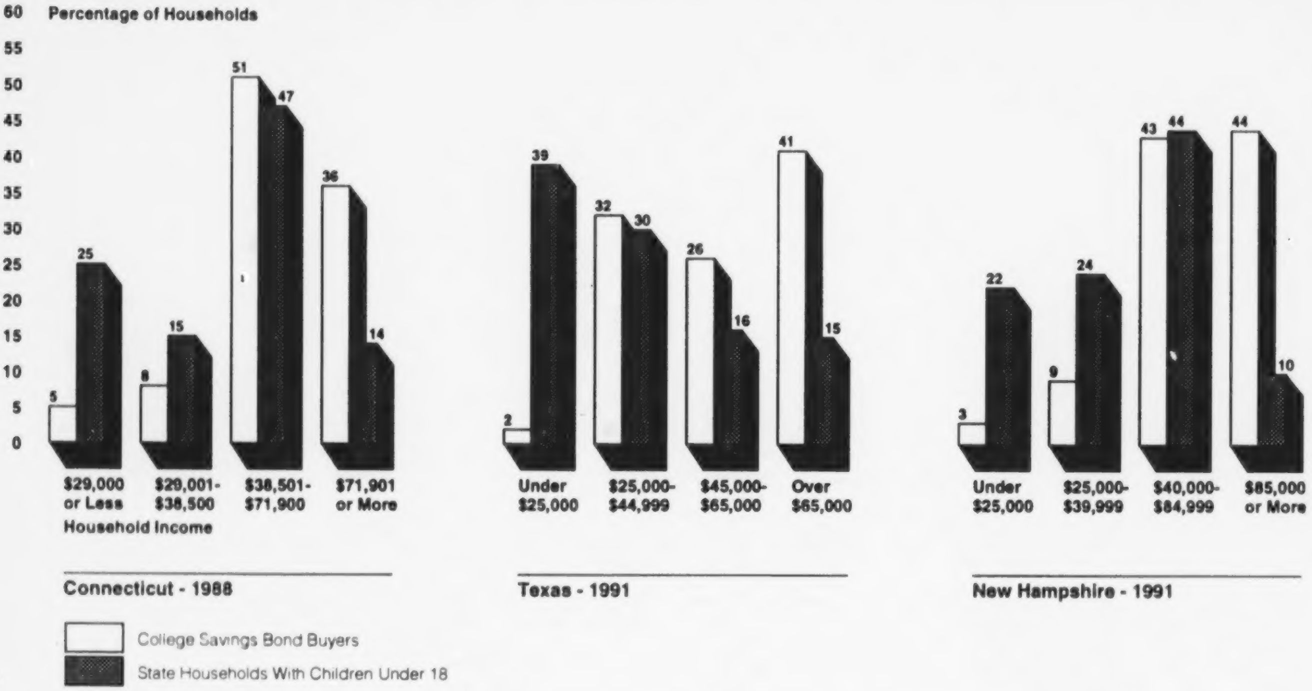
[27] These are the only three states for which we found income data on college savings bond buyers. However, we cannot be sure whether the data are representative of all bond buyers in these states: the numbers of respondents in Connecticut and Texas were not reported; New Hampshire's data were based on only 90 respondents out of 1,856 buyers.

Figure 3.5: Income Levels of College Savings Bond Buyers in Three States, Compared With All Households in These States



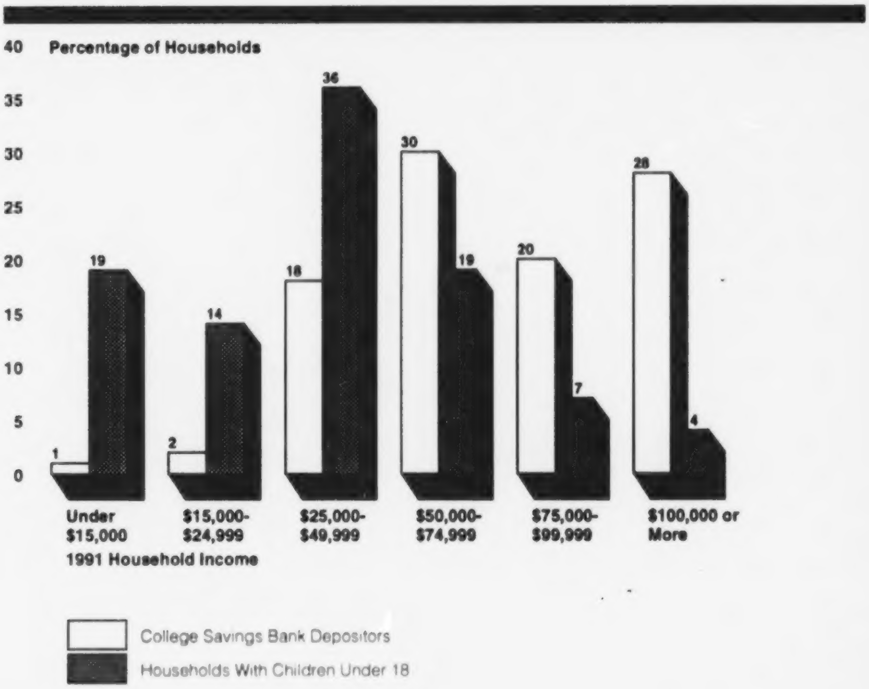
Note: Percentages may not add to 100 because of rounding. Sampling errors for CPS estimates do not exceed plus or minus 8 percentage points.

Sources: Connecticut Treasurer's Office, Texas Veterans Land Board, New Hampshire Family College Savings Plan, and Bureau of the Census' 1989 and 1992 Current Population Surveys.

As for another type of state initiative—Kentucky's program, in which parents establish special college savings accounts—a 1991 survey of participants found that the median gross family income was $50,000. In contrast, according to data from the Census Bureau, the median gross family income for all Kentucky households with children under age 18 was $28,020.

And as for options in the private sector, the College Savings Bank, which sells CDs indexed to increases in college costs, also draws its depositors disproportionately from middle- and upper-income groups (see fig. 3.6). A survey of its clients found that in 1991 only about 3 percent had pre-tax household incomes under $25,000, while about 78 percent had incomes of $50,000 or more, including about 28 percent with incomes of $100,000 or more.[28] In contrast, about 33 percent of all American households with children under age 18 had total incomes of under $25,000, about 30 percent had incomes of $50,000 or more, and only about 4 percent had incomes of $100,000 or more.

Figure 3.6: Income Levels of College Savings Bank Depositors, Compared With All U.S. Households With Children Under 18



Note: Percentages may not add to 100 because of rounding. Sampling errors for CPS estimates do not exceed plus or minus 1 percentage point.

Sources: College Savings Bank and Bureau of the Census' 1992 Current Population Survey.

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[28] These percentages are based on responses by approximately 980 of the 5,750 households participating in the savings program at the time, and we cannot be sure whether these respondents are representative of all participants.

Major Issues Concerning State Tuition Prepayment Programs

From the beginning, state tuition prepayment programs have received mixed reviews, with critics and supporters voicing a wide range of arguments for and against these programs. Some of the most commonly discussed issues have been whether the programs have a negative impact on students' choices regarding college attendance, provide an unnecessary benefit to middle- and upper-income families, are a good investment for purchasers, and pose too much risk for states. An overriding issue, however, has been the potential applicability of federal tax provisions. This is the most significant problem or barrier that state officials told us they encounter in trying to establish and operate a tuition prepayment program.[29] Nearly 8 years after the first such program started operating, state officials are still uncertain about the federal tax liability of the participants as well as the programs themselves. Applying certain tax provisions, state officials say, will make it considerably more difficult—perhaps even impossible—for these programs to succeed.

Potential Impact on Student Choice

One issue concerning state tuition prepayment programs is that they might limit or bias students' educational choices. Some critics have argued that by purchasing tuition benefits in advance, parents lock their children into attending a limited set of public colleges. Also, some have argued that because these programs guarantee to fully cover future costs only at in-state public colleges, beneficiaries will feel pressured to enroll in one of these schools, even though they may have sound personal or educational reasons to enroll at an in-state private or out-of-state college.

The notion that beneficiaries in these programs can only attend in-state public colleges is not supported. Our review of the rules governing existing state tuition prepayment programs found that, in general, benefits are portable to nonparticipating institutions; that is, beneficiaries may apply the value of their prepaid benefits toward the cost of attending in-state private and out-of-state colleges (see table 4.1).

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[29] Additional problems that program officials mentioned in interviews are summarized in app. II.

Table 4.1: What Happens If a Beneficiary Chooses to Attend a Nonparticipating College?

Alabama	Program pays to student's chosen school the average current in-state rate for tuition and fees or the amount the school charges, whichever is less.
Alaska	Student receives refund in amount of in-state tuition rate or cash value of account, whichever is less. Refund check is made out jointly to student and chosen school.
Florida	For in-state private colleges, program pays value of in-state public tuition to student's chosen school. For out-of-state colleges, program pays to student's chosen school the in-state tuition rate or the purchase price plus 5 percent interest, compounded annually, whichever is less.[a]
Michigan	Students can either direct payment to chosen school or request a refund. For in-state private schools, program pays the weighted average tuition of in-state 4-year public colleges; for out-of-state schools, program pays the nonweighted average tuition of in-state 4-year public colleges. For students who request a refund, program pays designated recipient the lowest tuition charged by a 4-year Michigan public college.[b]
Ohio	Program pays to beneficiary the weighted average tuition of in-state public schools.
Pennsylvania	Program pays to chosen school the lesser of (1) the school's tuition rate, (2) the actual tuition for the number and type of credits purchased, or (3) the value of the student's account.
Wyoming	Student must cancel contract, but receives refund of purchase price plus 4 percent interest, compounded annually.

[a] Rule in effect since 1993; previously, benefits were not portable out of state. Also applies only to baccalaureate-granting schools, not out-of-state community colleges.

[b] Rule for the full-benefits contract, which was purchased by about 96 percent of program participants.

It may be true that some beneficiaries will decide to enroll at an in-state public college simply because their tuition costs at such schools will be fully covered by their prepaid benefits. However, students might make similar decisions if they were to accumulate the same amount of money for college through any other means, such as a state college savings bond, a CD, or a stock mutual fund. Budget constraints commonly play a role in students' decisions about which college to attend.

Although we did not try to determine whether beneficiaries who have begun using their benefits felt constrained in choosing a college to attend, we did learn that in four states, many program beneficiaries have applied the value of their prepaid tuition benefits toward the cost of attending nonparticipating colleges.[30]

- In Alabama, of the approximately 600 beneficiaries who used their benefits in the fall of 1994, at least 14 percent were attending an in-state private or out-of-state school.
- In Florida, of the 12,093 beneficiaries who used their prepaid tuition contracts in 1994, about 2 percent attended an in-state private college and about 3 percent attended an out-of-state college.
- In Michigan, of the 4,063 beneficiaries who were enrolled in college in the fall of 1994, about 18 percent were attending an in-state private or out-of-state school and had arranged for the program to send the dollar value of their contracts directly to their chosen school.[31]
- In Ohio, of the beneficiaries who began using their benefits by the fall of 1994, about 10 percent had enrolled at private in-state schools and about 11 percent used their benefits at an out-of-state school.

Finally, on the basis of college attendance patterns, it seems very likely that most beneficiaries would choose to attend an in-state public college even if they were not participating in a state tuition prepayment program. In the fall of 1992, for example, about 72 percent of all first-time college freshmen in the United States were enrolled in a public 2- or 4-year college in their home state (see fig. 4.1). Furthermore, in most of the seven states with tuition prepayment programs, the percentage of first-time freshmen enrolled at in-state public colleges was close to the national average.

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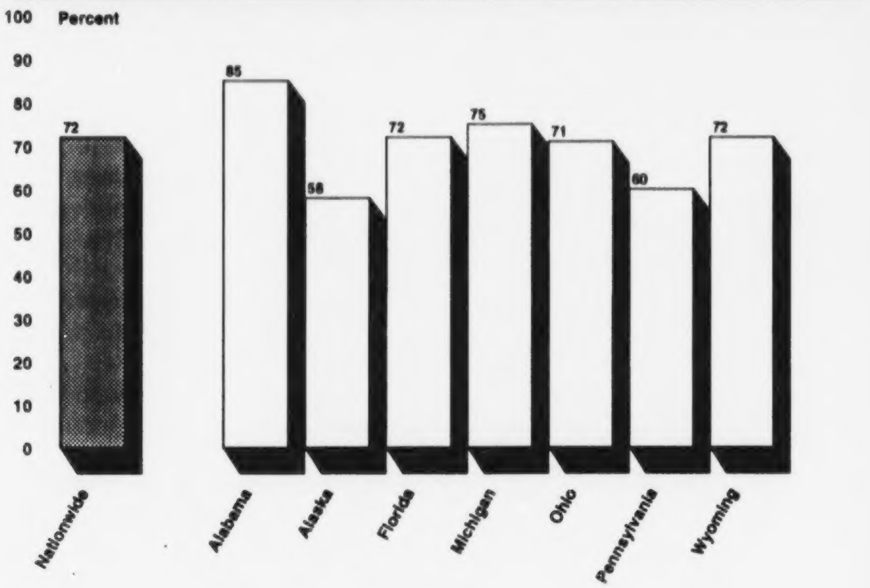
[30] In the remaining three states, substantial numbers of beneficiaries have not yet enrolled in college.

[31] These figures include all three types of MET prepaid contracts.

Figure 4.1: Most First-Time Freshmen Attend a Public College in Their Home State



Source: U.S. Department of Education, National Center for Education Statistics, Integrated Postsecondary Education Data System, 1992 Fall Enrollment Survey.

Programs Mainly Help Middle- and Upper-Income Families

Another issue surrounding these programs is that they appeal to mostly middle- and upper-income families. Some critics point out that these programs do little to help lower-income families finance a college education, and should not "take away from the primary goal we have of public policy, which is basically to equalize opportunity."[32] In addition, some have raised equity concerns because of the subsidies that these programs may provide to participants. Supporters argue, however, that not every government program must redistribute wealth from the rich to the poor, and that increased saving by middle-income families will reduce their need for financial aid, thus making more of these resources available to lower-income students.

Our work showed that state tuition prepayment programs can provide various subsidies to participants. First, the discount prices offered by the programs in Michigan and Alabama represent a subsidy to participants on top of what they would receive through state subsidization of higher education. A second subsidy can come in the form of state expenditures for program operations. For example, (1) Alabama's program received $500,000 in start-up costs, which it was not required to repay;[33] (2) Ohio's program received a $1 million appropriation in 1994 for operating expenses; and (3) Alaska's program does not collect enough in participant fees to fully cover its administrative costs, so these expenses—currently about $200,000 per year—are paid mostly out of unrestricted university funds.

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[32] Arthur Hauptman, comments made at the Invitational Conference on College Prepayment and Savings Plans, in Denver, July 7-8, 1987; see conference proceedings (New York: College Entrance Examination Board), p. 67.

Potential tax advantages represent a third type of subsidy to participants. Currently, purchasers are not required to pay federal income taxes annually on the increased value of their investment in the program; instead, beneficiaries are liable for federal taxes on the increased value of their benefits at the time of redemption.[34] Some states have also granted tax advantages to program participants. For example, in Alabama, Ohio, and Pennsylvania, beneficiaries are not required to pay state income taxes on the increased value of their benefits at the time of redemption. And in Michigan, purchasers are allowed to deduct the amount of their payments for state income tax purposes.

Some programs, however, operate without some of the subsidies mentioned. Most programs have priced their benefits close to the current cost of tuition, some slightly higher. In Ohio, for example, prepaid tuition credits are now priced about 8 percent above current tuition prices, and previously were priced about 35 percent above current prices. The programs in Ohio, Florida, and Michigan repaid the initial state appropriations (ranging from $300,000 to about $1 million) they were given as start-up funds. And in Alabama, staff salaries and other operating costs are now covered with application and other administrative fees paid by participants.

Furthermore, not all government subsidies are equitable in the sense that lower-income families benefit to the same extent as middle- or upper-income families. Sometimes, however, subsidies to certain income groups are, in a sense, balanced by different subsidies to other income groups. For example, while the mortgage interest deduction helps primarily middle- and upper-income families, there are also various housing subsidies for the poor. Similarly, while subsidies involved in state tuition prepayment programs primarily benefit families who are relatively well off, state and federal governments also subsidize higher education for lower-income families through various financial aid programs.

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[33] However, the board that oversees the program may decide to repay this money in the future, according to the program's Director.

[34] We discuss the perceived importance of these tax breaks for participants and the programs themselves later in this chapter.

Regarding whether these programs will free up substantial financial aid dollars for lower-income students, our review of federal financial aid rules and data from six major universities indicated that this probably will not occur. First, the vast majority of current beneficiaries do not appear to need financial aid. Most of them do not apply for aid, and those who do typically do not qualify. For example, of the 789 beneficiaries enrolled at Florida State University in 1993-94, 86 percent did not apply for aid, and of those who did, 72 percent were determined not to need assistance because (1) they and their parents had enough money—not even counting the value of their prepaid benefits—to cover all college costs, or (2) the combination of their family resources and merit aid, such as scholarships, exceeded anticipated costs (see table 4.2).

Table 4.2: Most Prepaid Beneficiaries Appear Not to Need Financial Aid—Data From Six Participating Institutions

Institution	Number of prepaid students enrolled	Percent who did not apply for financial aid	Of those who did apply, percent ineligible
Eastern Michigan University[a]	163	85	46
Michigan State University[b]	925	78	60
Florida State University[b]	789	86	72
University of Florida[b]	1,864	40	77
University of Central Florida[b]	692	74	35
Ohio State University[a]	103	49	53

[a] Data for 1994-95 academic year.

[b] Data for 1993-94 academic year.

Source: Estimates provided by financial aid offices at these six institutions.

Second, although federal financial aid rules have the effect of reducing the amount of aid that prepaid beneficiaries can receive, this will not translate into savings that can be passed along to other, potentially more needy students. Once the value of their prepaid benefits is taken into account, beneficiaries typically are eligible for a smaller guaranteed student loan than they would have been otherwise; for some, the aid reduction may mean not qualifying for a loan at all. But the money that goes unborrowed by prepaid students does not then become available to other students, because, unlike grants, there is no fixed amount of money allocated each year for guaranteed student loans. Rather, lenders will provide loans to as many students as qualify.

Investment Value for Purchasers

A third issue concerning these programs is their value as an investment option. One common criticism is that purchasers could lose some or all of the interest on their principal if (1) the beneficiary does not to go to college at all or attends a nonparticipating college; (2) the purchaser withdraws from the program; or (3) the program is terminated. Some critics have also argued that even if beneficiaries do use their benefits as intended, purchasers can simply earn a higher return from other investments, such as stocks. Supporters, on the other hand, argue that these programs (1) have resources and expertise that enable them to invest more effectively than the average family can on its own; (2) provide an easy and affordable way to save for college; (3) offer a unique psychological benefit—peace of mind—because of the guarantee to cover future costs; and (4) may have tax advantages over other investment options.

To determine whether purchasers could potentially earn a better return on their money from other investment vehicles than from tuition prepayment programs, we compared the effective annual rate of return on large company common stocks with the effective annual rate of inflation for tuition and fees at public universities over more than a dozen 15-year periods, up to 1993.[35] Over most of these periods, the stocks provided a higher rate of return than the rate of tuition inflation for public universities (see fig. 4.2).

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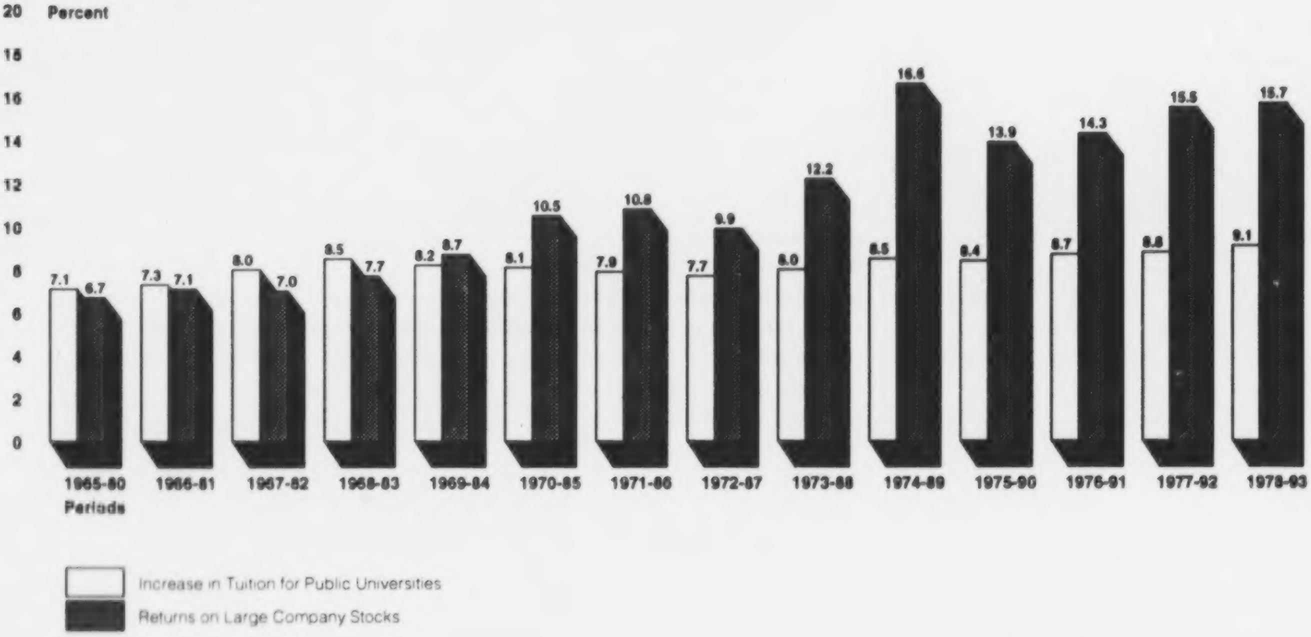
[35] The effective rate of return, also sometimes referred to as the annualized rate of return, is greater than the simple arithmetic average of individual interest rates, because it includes compounding during the investment period.

Figure 4.2: Tuition Increases, Compared With Returns on Stocks Over 15-Year Periods



Sources: SBBI 1994 Yearbook (Chicago: Ibbotson Associates) and U.S. Department of Education

However, while parents could earn a higher return from other investment vehicles, it is not at all certain that they would. With alternate investment options, parents take the risk that they may not end up with enough money when their children are ready to enroll in college. Even stocks have not always kept pace with tuition increases at public universities. For example, as shown in figure 4.2, during the 15-year periods ending in 1980 to 1983, tuition inflation exceeded the effective rate of return on large company common stocks. Thus, parents beginning to save for their children's college educations in 1965-68 would have done better by joining tuition prepayment programs, had they existed, than by investing solely in stocks.

To beat the tuition inflation rate over the long run, investors would need to (1) put the right amount of money in the right investment vehicles at the right time and (2) not use the money for other purposes before their children reach college age. Would the participants in state tuition prepayment programs make the correct investment choices? On the basis of evidence from one state, it seems likely that many would not. When asked on Alabama's program application how they would save for college costs without the tuition prepayment program, about 52 percent of purchasers in 1991-94 checked "savings account," about 17 percent checked "savings bonds," about 15 percent checked "life insurance," and only about 6 percent checked "stocks."[36] With passbook savings accounts currently offering interest rates of less than 3 percent, it appears that a large percentage of Alabama's participants would be putting their money in investments that would be expected to provide a lower return than the anticipated rate of tuition inflation, about 7 percent to 8 percent per year.

Purchasers apparently see the risk of losing some of the interest they accumulate in tuition prepayment programs as outweighed by other benefits of program participation. Limited evidence to support this position comes from a 1992 report by the Florida Auditor General's office, which asked a sample of purchasers to describe what they saw as the advantages and disadvantages of the state's tuition prepayment program. As for the disadvantages, 35 percent of participants referred to losing interest on the money paid into the program if the beneficiary did not use the prepaid benefits at all, and 11 percent mentioned that beneficiaries could not use their benefits at an out-of-state college.[37] Many more participants, however, identified various advantages of the program: About 67 percent mentioned the guarantee to cover future educational costs with payments based on today's prices; 42 percent mentioned that paying now instead of later gave them peace of mind; and 33 percent referred to the availability of easy, affordable payment options.[38]

Finally, regarding the tax advantages that these programs may have over other investment choices, certain advantages could be eliminated in the future. We discuss this possibility in greater detail in the final section of this chapter.

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[36] The remaining 11 percent checked "other." Source: Data provided by Alabama program officials.

[37] At the time of the survey, beneficiaries who wanted to attend an out-of-state college would have received the principal from their contracts, but no interest.

[38] Office of the Auditor General, State of Florida, Performance Audit of the Florida Prepaid Postsecondary Education Expense Program, Report No. 11825 (Mar. 25, 1992). Responses cited are for participants whose designated beneficiaries had not yet enrolled in college. Response totals exceed 100 percent because respondents were allowed to cite more than one advantage and disadvantage.

Risk to States

A fourth major issue surrounding state tuition prepayment programs is the degree of risk they pose for states. A key criticism is that they may not earn sufficient investment returns, thus leaving the state with a large, unfunded liability. A program shortfall, or even the threat of one, could lead to many undesirable outcomes, such as a taxpayer bailout, reduced spending on higher education, or lower-than-anticipated tuition increases at state colleges. In contrast, supporters claim that the risk of a shortfall can be minimized, so long as the programs properly price their benefits; make sensible actuarial assumptions; and develop a diversified, though aggressive, investment portfolio. Some also argue that safeguards can be adopted to protect against excessive losses, such as an "escape clause" that allows the state to suspend or terminate the program quickly if it is determined to be actuarially unsound.

We found two instances in which tuition prepayment programs were suspended because they appeared headed for financial trouble. First, Duquesne University, a private institution in Pittsburgh, Pennsylvania, implemented its own tuition prepayment program in 1985 but suspended it just 3 years later, because investment returns were running lower than expected and the school wanted to raise tuition faster than originally anticipated. Second, Michigan's tuition prepayment program stopped selling new contracts after 3 years, at least in part because of state officials' concerns about its ability to meet its future obligations.[39] The Director explained that MET's investment returns had dropped somewhat, making it harder to keep up with state tuition inflation—especially because the program was also required to pay federal taxes on its earnings. However, the program Director also pointed out that the program is still actuarially sound.

The experiences of Duquesne and MET may help other program officials avoid similar problems. For example, both programs offered deep discounts on contracts for younger children. According to one analysis of Duquesne's program, in 1986 the cost of a 4-year contract for a child planning to begin college in the year 2000 was $9,182, while the cost of tuition for the 1986-87 academic year alone was $6,270.[40] Such low prices mean that investment returns must not only keep pace with but substantially exceed the rate of tuition inflation. Most of the state programs, though, have not offered such deep discounts and some have even charged prices slightly higher than the current cost of tuition at participating colleges.[41]

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[39] Some MET supporters have argued that the suspension was also politically motivated.

Finally, if a state tuition prepayment program were facing financial trouble, it is unclear which, if any, of the predicted outcomes would occur. In addition, whether these outcomes would be negative is a matter of opinion; what one observer sees as unacceptable might be acceptable to another. For example, some people might oppose a state bailout on equity grounds, as a subsidy to relatively well-off families. In contrast, the Michigan Treasurer who helped develop MET once said, "So we go through that horrible scenario of the state government bailing out a system so 10,000 kids can go to college. But what better way to spend the taxpayers' dollars than on educating kids? The worst is that we're spending more money on education than we might have been planning instead of spending it on dredging some lake that some legislator sits on."[42] Similarly, requiring state colleges to keep down their tuition prices could be seen as impeding the colleges from carrying out their educational mission or as helping to keep college affordable and accessible to families of modest means.

Applicability of Federal Tax Provisions

The most serious issue facing state tuition prepayment programs, according to program officials, is the potential applicability of federal tax provisions. Which provisions apply now, or may apply in the future, is unclear. Program officials are particularly troubled by the possibility that IRS will require (1) programs to pay taxes on their investment earnings and (2) participants to pay taxes annually on program benefits.[43]

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[40] Presentation by John Finnerty at the Invitational Conference on College Prepayment and Savings Plans, in Denver, July 7-8, 1987; see conference proceedings (New York: College Entrance Examination Board), pp. 25-31.

[41] Programs' efforts to avoid the tax liability that contributed to MET's problems are described later in this chapter.

[42] Robert Bowman, comments made at the Invitational Conference on College Prepayment and Savings Plans in Denver, July 7-8, 1987; see conference proceedings (New York: College Entrance Examination Board), pp. 18-19.

[43] This section presents a brief overview of federal tax issues; a more complete discussion is presented in app. III.

Michigan's History of Tax Problems

Much of the concern over federal taxation stems from the experience of Michigan's pioneering program. Before MET sold any contracts, it requested a ruling from IRS on the applicability of federal tax provisions. IRS ruled in March 1988 that (1) purchasers may be liable for the federal gift tax, (2) beneficiaries would be liable for federal income taxes on the increased value of their benefits at the time of redemption, and (3) MET itself would have to pay federal taxes on its investment earnings. Although some observers saw the ruling as unfavorable—especially the requirement that MET pay taxes on its investment earnings—the program began selling prepaid tuition contracts in the fall of 1988.

In 1991, however, when lower investment returns made it more difficult to stay ahead of tuition inflation, MET suspended sales and requested a full refund of the $15.8 million it had paid in taxes for its first 3 years of operation. When IRS denied the refund request, MET and the state of Michigan sued the United States, arguing that the program's investment earnings were exempt from federal taxes because the program is an integral part of the state. MET lost in U.S. district court in July 1992, but won its appeal in the Sixth Circuit Court of Appeals in November 1994. Although IRS disagreed with the Circuit Court's decision, the Solicitor General recently decided not to appeal the case to the U.S. Supreme Court.

Some States Defer Action Because of Tax Concerns

After the IRS ruled on MET, several states that had been interested in starting tuition prepayment programs backed away from the idea. Indiana decided not to implement such a program after receiving its own ruling from IRS in September 1988, which indicated that the proposed program would be subject to federal taxes on its investment earnings. One state official said, "We didn't feel that we could keep up with tuition costs that are rising about 9 percent a year. We would have to earn a return of around 13 percent before taxes to get 9 percent after taxes."[44] Also, 1994 legislation authorizing a tuition prepayment program in Virginia stipulated that it cannot begin selling contracts until IRS rules that the program's investment earnings are exempt from federal taxation.

Efforts to Avoid Tax on Program Earnings

In light of Michigan's experience, states that implemented programs have tried to structure them more clearly as an integral part of the state. For example, in some states the program is within and under the direct control of the state Treasury Department, and in others the program is administered by the state's higher education system. Thus far, IRS has emphasized that backing these programs with the full faith and credit of the state may help protect their investment earnings from federal taxation, because it demonstrates the state's financial stake in the program. However, some officials told us that their states have not taken this step because it is prohibited by their state constitutions. Florida's program is the only one to operate with the full faith and credit of the state from its inception. By statute, in the event of a shortfall, the legislature must provide the program with the funds it needs to meet its obligations. Also, in 1994, Ohio citizens approved a constitutional amendment that enabled the state to back the tuition prepayment program with its full faith and credit.

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[44] Cited in Jacqueline Mitchell, "Michigan Flunks Its Tuition Trust Fund," Wall Street Journal (Mar. 26, 1992), p. C16.

Annual Tax Liability for Participants Also a Concern

Although IRS rulings apply only to the parties who request them, program officials in other states have generally interpreted IRS's ruling on the tax consequences for MET purchasers and beneficiaries as applicable to their programs, too. And, in general, these provisions are not considered a hindrance to successful program operation. But program officials are concerned that IRS may change its opinion on the tax liability of program participants. Specifically, IRS has indicated that regulations on contingent debt recently proposed by the Department of the Treasury could be interpreted as applying to tuition prepayment programs. This interpretation could result in either purchasers or beneficiaries being liable for federal income taxes annually on the imputed interest on their investment in these programs.

Program officials believe that such a tax would hurt program operations. First, they argue that purchasers would not understand or be receptive to paying taxes on income they had not personally received (sometimes referred to as "phantom income"), and as a result, program sales would decrease significantly. Second, they claim that notifying participants of this tax liability every year would be an administrative burden. Some program officials recently expressed these views in letters to IRS and in testimony before IRS and Treasury officials on the proposed regulations.

Some Programs Awaiting IRS Rulings

Like Michigan, some of the other states with tuition prepayment programs also requested IRS rulings to clarify their federal tax consequences. But none of the states has received a ruling; Florida and Ohio have been waiting 5 years. IRS officials told us that rulings on other programs would likely be delayed while the MET case was in litigation. However, even though litigation concerning MET has now ended, rulings on other programs may not be immediately forthcoming, and tax questions could remain unanswered even longer. For example, IRS may wait until Treasury issues the final regulations on contingent debt, expected late this summer, because they could determine how IRS rules on the federal taxes applicable to program participants. In addition, IRS could audit an existing program that it believes is liable for federal taxes on its investment earnings. If ordered to pay these taxes, the program might then challenge IRS in court, further postponing the issuance of rulings while the case is in litigation.

Chapter 5

Concluding Observations

In response to rapidly rising costs of higher education, several states have implemented tuition prepayment programs. These programs are intended to ease families' concerns that they will not have enough money in the future to cover the costs of their children's college educations. Each of the seven programs we reviewed is uniquely designed and structured, although they all operate in a generally similar manner.

Judging by their overall participation rates, the programs have had varying degrees of success. However, the programs are fairly new and are still learning how best to package and market their benefits and reach potential purchasers. Most participants in these programs are from middle- or upper-income families—families that can afford to save and will be expected to pay for a significant proportion of their children's future college expenses. These programs are probably not a viable option for most lower-income families.

In deciding whether to establish a tuition prepayment program, and in later operating such a program, states face a variety of issues and potential problems. For example, there have been long-running debates over what effect these programs might have on beneficiaries' educational choices and the degree of risk they pose to states. Some of the issues represent matters of opinion and differing philosophies and therefore cannot be resolved through empirical analysis.

Regarding the issue of federal taxation, nearly 8 years after Michigan first raised questions about the applicability of various federal tax provisions to these programs and their participants, the issues are still unresolved. This constitutes a significant problem for these programs, because certain tax consequences can have a negative impact on program operations. Officials in some states are concerned about which tax provisions apply to their existing programs, and officials in other states have deferred implementation of such programs pending more clarification of the tax issues. Furthermore, if state officials have to wait for IRS and the courts, several more years could pass before some resolution is reached—and there is no guarantee the resolution will be favorable.

On one hand, federal legislation could significantly speed up resolution of these issues and ensure that resolution is favorable. For example, the Internal Revenue Code of 1986 could be amended to exempt these programs' investment earnings from federal taxation and to exclude purchasers and beneficiaries from having to pay federal taxes annually on the imputed interest on their investments in these programs. In fact, legislation addressing some of the tax issues concerning these programs and their participants has been introduced in the current Congress and in the past.[45]

On the other hand, the problem of federal taxation could be resolved in other ways. For example, IRS could issue a favorable letter ruling for one or more programs, which might send a clearer message to other states about what it takes to establish a program that IRS considers an integral part of the state, and whose investment earnings are exempt from federal taxation. IRS could even take a different position on these issues than it did concerning MET. Treasury officials could heed the comments of prepayment officials on the proposed contingent debt regulations and either explicitly exempt these programs from the regulations, or indicate to IRS that it should not interpret them as applying to tuition prepayment programs.

In addition, before pursuing a legislative resolution, several other factors would need to be considered. For example, what impact, if any, would exempting these programs' investment earnings and beneficiaries from annual federal taxation have on private sector financial institutions and intermediaries? The head of the College Savings Bank (see ch. 1) has argued that without creating similar tax advantages for private sector college savings options, such legislation would "distort investor choices" and "crowd out virtually all private sector competition in the marketplace."[46]

Enacting the kind of tax provisions favored by program proponents could also have an uncertain impact on federal revenues. For example, if the money purchasers spend on prepaid tuition benefits would have otherwise been put in taxable investment vehicles, the federal government would lose potential tax revenues. On the other hand, exempting the programs' investment earnings might not be considered a loss to the federal treasury, because the programs are not paying taxes now on their interest income. Nonetheless, these kinds of potential costs would have to be weighed against the perceived benefits of legislation aimed at resolving the tax problems currently facing state tuition prepayment programs.

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[45] See, for example, H.R. 1328, 104th Cong., and H.R. 2404, 100th Cong.

[46] Peter A. Roberts, "Market-Based Solutions: Federal and State Legislative Alternatives to Increase the Rate at Which Families Save for College" (prepared statement presented at the Third Annual Conference of the College Savings Plans Network in New Orleans, July 9, 1994).

Agency Comments

We discussed a draft of this report with IRS officials, who agreed with the discussion of federal tax issues concerning these programs. Officials from all seven state tuition prepayment programs also reviewed the information in this report, and they agreed with our characterization of the issues and descriptions of their programs. Where appropriate, we incorporated minor wording changes suggested by IRS officials and state program officials.

Overview of Tuition Prepayment Program Features

The tuition prepayment programs in each of the seven states have in common the guarantee that parents can "lock in" future college tuition at today's program prices. However, each state's program is unique in terms of the benefits offered and the rules governing eligibility, benefit redemption, refunds, and so forth. This appendix presents detailed descriptions of the programs in Alabama, Alaska, Florida, Michigan, Ohio, Pennsylvania, and Wyoming.

Alabama

Alabama enacted the Wallace-Folsom Prepaid College Tuition Trust Fund Act in 1989, establishing the Prepaid Affordable College Tuition program. Since 1990, the program has sold contracts guaranteed to cover up to 4 years of undergraduate tuition and required fees at any public college or university in the state, including 2-year and 4-year schools. There are 50 eligible institutions in the state. The Alabama State Treasurer's Office administers the program, under the guidance of a 10-member board of trustees. Contract payments are received and invested in the Wallace-Folsom Prepaid College Tuition Trust Fund.

Educational Benefits

The tuition benefit covers up to 135 semester hours, or the equivalent at schools on another academic term basis. The fee benefit covers mandatory fees for 8 registrations on a semester system, or 12 registrations on the quarter system, or the equivalent number for schools on a different academic term basis.

Enrollment Process

To qualify, beneficiaries must be in the eighth grade or less. They must also be either a resident of Alabama or the child of a noncustodial parent who is a resident. Children of military personnel whose "home of record" is Alabama are also eligible. The program allows only one purchaser per contract. However, people other than the purchaser may make payments. Enrollment takes place from May 1 through May 31 each year. The program charges a $75 nonrefundable application processing fee.

Purchasers can make a single payment for 4 years of tuition, or choose one of two monthly payment plans. Under the 5-year payment plan, purchasers make 60 equal monthly payments. This plan is only available for beneficiaries in the sixth grade or less. The extended payment plan calls for equal monthly payments from contract initiation until the beneficiary reaches college age. For both monthly payment plans, the program provides coupons, which the purchasers send in with their checks.

Payments can also be arranged through automatic deductions from bank accounts or through direct deposit from the purchaser's employer. Monthly payments begin September 1 of each year; single payments are due July 1. Purchasers may change their payment schedule during the enrollment period in which the contract is initiated for a $15 fee. The window of opportunity begins the month in which the contract is purchased and ends the 15th day of the month when their first payment is due. The charge for late payments is $15.

Purchasers who choose one of the monthly payment plans are permitted to pay off the contract balance at any time. Purchasers can also pay more than the required monthly payment amount at any time, which will reduce the total number of payments, but not the monthly payment amount. The contract must be fully paid off, including any outstanding fees, before the beneficiary can use the benefits.

Price Structure

Contract prices vary by the age of the beneficiary and the length of time over which the contract will be paid off. In 1993, the single payment for an eighth grade student was $7,961; for an infant the price was $4,892. Under the 5-year payment plan, the monthly payment for a sixth grader was $156; for an infant it was $105. The extended payment plan cost $203 for an eighth grader and $50 for an infant. The prices reflect the weighted average cost of tuition and fees at state schools. Tuition and fees for 1992-93 ranged from $945 at Wallace Community College to $2,269 at the University of Alabama, Huntsville.

Redeeming Prepaid Benefits

Beneficiaries have 10 years from the projected date of enrollment to use all benefits. Extensions may be granted for military service. Beneficiaries must still meet in-state residency requirements for the Alabama school they attend, regardless of the purchaser's residency at the time of enrollment. If beneficiaries are ineligible for in-state tuition, they must pay for any remaining costs.

Program Flexibility

The program makes several allowances for benefits to be refunded, transferred, or used at nonparticipating institutions. For example, benefits can be used at any private or out-of-state institution. The program sends to the institution an amount based on the average cost of tuition and fees at Alabama's public 4-year colleges and universities, or the cost of tuition and fees at the beneficiary's school, whichever is less. The program charges

$25 for each term that the beneficiary uses the benefits at a nonparticipating school.

Beneficiaries may also transfer among any of the Alabama public colleges and universities. For instance, a student may transfer to a 4-year institution after completing a community college. Also, a student may transfer from one 4-year university to another.

If the beneficiary gets a scholarship, the program will pay the school as if it had not been received, and then the purchaser can request a refund from the institution for overpayment.

If a beneficiary starts college and then stops, the program will refund the remaining benefits, minus a $150 cancellation fee. The program will pay the refund to the beneficiary over a period of time. However, once a beneficiary starts college, he or she may not transfer the benefits to someone else. If the beneficiary decides not to go to college, he or she may receive a refund of the unused benefits.

Benefits may be transferred, instead of refunded, only if the beneficiary has died, received a scholarship, or never enrolled in school. Benefits can only be transferred to a younger member of the beneficiary's immediate family, or another child, if approved by the board, for a $55 fee.

Also, purchasers can cancel their contracts for a refund before the beneficiary reaches college age. However, the program will deduct cancellation and administrative fees, which includes the account maintenance fees. The cancellation fee is 50 percent of the amount paid into the fund or $150, whichever is less. However, no cancellation fee is charged if the child dies or becomes disabled. The purchaser will receive a refund of the current value of the contract.

Ownership of the contract can be transferred by naming a new purchaser, subject to written authorization of the original purchaser. The transfer fee is $20, but this is waived if the contract has to be transferred because of the death of the purchaser.

Additional Features

As an added feature for participating in the program, purchasers who qualify can receive a lower interest rate on one particular credit card. The "Alabama's Future Card" is a Visa card offered through Colonial Bank, in a joint venture with the state. Purchasers can receive a 15.5 percent annual percentage rate, while regular card holders pay 16.9 percent. In addition, a percentage of all sales is donated to the state of Alabama to benefit four programs for children, including the Prepaid Affordable College Tuition program.

Alaska

Alaska established the Advance College Tuition program in April 1991, and the program began selling tuition credits that fall. The tuition credits may be used at the University of Alaska, the only state university in Alaska, which includes three regional campuses and a community college. The University of Alaska Board of Regents administers the program.

Educational Benefits

Participants purchase tuition credits toward undergraduate or graduate education at the University of Alaska. For an undergraduate degree, each tuition credit is redeemable for one undergraduate semester credit hour. For graduate education, two tuition credits are worth one graduate semester credit hour. It generally takes at least 120 credit hours to complete a bachelor's degree. The number of credits for a graduate degree varies according to the course of study undertaken.

Enrollment Process

Purchasers may be any person, institution, or business, and only one purchaser may be named on each agreement. Purchasers must designate a primary beneficiary, and also may name up to three alternate beneficiaries in the event that the benefits are not used by the primary beneficiary. Purchasers may name anyone they choose as beneficiaries, regardless of their relationship to one another. Purchasers may even name themselves as the beneficiary.

Neither purchasers nor beneficiaries are required to be residents when applying to the program. However, to qualify for resident tuition status at redemption, beneficiaries must have been a resident of Alaska, or the child or legal ward of a resident or of an alumnus of the university, when the agreement was established, at the time of redemption, or any time in between.

To begin the program, purchasers must buy a minimum of six tuition credits. Purchasers also pay a nonrefundable $50 contract initiation fee. Thereafter, purchasers may buy a minimum of one credit per purchase. Although new prices go into effect each January, enrollment takes place year-round.

Purchasers can make payments at any time using checks or money orders. In addition, they can also designate up to 50 percent of their annual Permanent Fund dividend to purchase tuition credits. Purchasers who are the legal guardian of a beneficiary may also use the beneficiary's dividend to purchase tuition credits for that child. Purchasers receive regular account statements to apprise them of the account's progress.

Price Structure

The program charges purchasers roughly the current cost of tuition at the time they make each payment. Prices are adjusted each year to reflect tuition increases. For instance, the cost of one tuition credit in 1993-94 was $66; in 1994-95, a tuition credit was $71. The cost of one tuition credit for the 1995-96 academic year will be $78, making the single payment cost of 4 years of undergraduate education $9,360.

Redeeming Prepaid Benefits

In order to use the tuition credits, beneficiaries must notify the program at least 3 months prior to the time they plan to start college. They must let the program know the number of credits they plan to use, and indicate how many will be used for tuition. They must also specify the institution they plan to attend. The program will then issue the student a tuition waiver to be used at registration. Beneficiaries may begin using credits 2 years after joining the program. In addition, beneficiaries have up to 15 years after their anticipated college enrollment date to begin using the credits.

Program Flexibility

The program allows purchasers and beneficiaries to receive refunds in various amounts based on the reason for the refund. In addition, alternate beneficiaries may use credits under certain circumstances.

Refund amounts are calculated in three ways—the cash value of the credits, the tuition value, and the purchase price. The cash value is the value of a tuition credit based on earnings and market value of the fund investments, the outstanding tuition credits, and other actuarial adjustments. Tuition value means the value of a tuition credit based on a weighted average of the University of Alaska resident undergraduate tuition rates. The purchase price means the amount paid by the purchaser for tuition credits, not including any investment earnings or outstanding fees.

Primary beneficiaries qualify for a refund of the cash value if they become disabled. If the beneficiary dies, the estate of the primary beneficiary will receive a cash-value refund, unless an alternate beneficiary was named.

Primary beneficiaries qualify for a refund of the tuition value, not to exceed the cash value, if they (1) attend a nonparticipating institution, (2) fail to gain admittance into the University of Alaska, (3) have unused credits after completing college, or (4) have more than enough credits to graduate. In the latter two cases, the refund only includes unused benefits.

If a beneficiary gets a full tuition scholarship, the plan will reimburse the student at that year's fixed cost, for each semester he or she has the scholarship. The value of the benefits can then be used to pay for other costs of attendance, such as books, transportation, and room and board. If a beneficiary gets a full scholarship covering all costs of attendance, he or she may either save the credits for graduate school or get a refund. If the beneficiary chooses a refund, he or she will receive either the amount that would have been spent for tuition or the value of a tuition credit, which is based on the weighted average of the University of Alaska resident undergraduate tuition rates, whichever is less.

If the primary beneficiary quits college or decides not to go to college, the program will refund the purchase price for any unredeemed credits. Such refunds are paid out in four annual installments to discourage requesting refunds for short-term cash needs.

In most cases, if an alternate beneficiary is named, tuition credits are transferred to the alternate, rather than refunded to the primary beneficiary or his or her estate. For instance, if the primary beneficiary dies, does not go to college, or fails to gain admittance into the University of Alaska, the credits are transferred to an alternate beneficiary. In addition, if the primary beneficiary does not use any credits during any 6-year period after the anticipated college enrollment date, the program notifies the primary beneficiary that his or her credits will be transferred to the alternate beneficiary. In other circumstances, if a primary beneficiary has additional credits after finishing college or decides not to finish college, the unused credits will be transferred to the alternate beneficiary. Such a transfer leads to a 6-year extension of the time frame for using benefits.

Additional Features

The program has two additional features to encourage higher education attainment—graduation incentive awards and prepaid tuition scholarships. The program funds both of these features by allocating a portion of any excess amount of the prepaid tuition fund over the actuarial requirements to a special account for them each year.[47]

Beneficiaries may receive graduation incentive awards to encourage them to continue and complete their college education. Beneficiaries can earn one graduation incentive credit for each tuition credit redeemed or refunded for payment of tuition at the University of Alaska or any eligible institution. After a beneficiary earns a degree or equivalent certificate, he or she can either redeem the graduation credits toward graduate education or get refunds for a variety of other uses.

Prepaid tuition scholarships offer an incentive for younger Alaskans to achieve higher academic standards of performance in middle and high school and to complete their secondary education. Scholarships may be given to students in grades 6 through 12 who attend school in Alaska, and they can only be used for attendance at the University of Alaska.

Florida

Florida enacted the Florida Prepaid Postsecondary Education Expense Program in June 1987; the program began selling contracts for undergraduate prepaid tuition in the fall of 1988. The benefits are guaranteed to cover future education costs at Florida's 9 state universities and 28 community colleges. The program is backed by the full faith and credit of the state, meaning the state is required to appropriate to the trust fund an amount necessary to meet the program's obligations if the money in the trust fund is insufficient. The program is administered by the Florida Prepaid Postsecondary Education Expense Board, a state agency affiliated with the State Board of Administration.

Educational Benefits

The program offers three prepaid tuition plans, plus a prepayment plan for dormitory space. Participants can prepay the cost of undergraduate tuition and mandatory fees for 2 years at the community college level, 4 years at the university level, or 2 years at community college plus 2 years at a university. Purchasers of the 4-year university plan only can also prepay the cost of dormitory space for up to 5 years. The dormitory contract covers the cost of a double-occupancy, air-conditioned room.

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[47] According to program officials, these features are not yet offered because the fund does not have any excess proceeds.

Enrollment Process

When the contract is purchased, the beneficiary must be a state resident or the child of a noncustodial parent residing in Florida. Children of military personnel for whom Florida is their "home of record" are also eligible to participate. Beneficiaries must also be below the twelfth grade.

Purchasers need not be a relative of the beneficiary; even corporations, businesses, and civic and fraternal organizations can purchase a contract. Two people may jointly purchase a contract, but no provisions can be made for separate or split payments.

Beneficiaries can only have one tuition and dormitory plan. Prepaid dormitory contracts are restricted to beneficiaries in the eighth grade or lower. In addition, housing benefits are for fall and spring semesters only; they may not be used during summer sessions.

For each benefit plan, the program offers three payment plan options: (1) the single-payment plan, in which the contract is paid for with one lump-sum payment; (2) the 5-year installment plan, in which purchasers make 55 monthly payments; and (3) the monthly payment plan, in which payments are made from the time of purchase until the beneficiary's projected enrollment year. The 5-year installment plan is only available to purchasers if the beneficiary is in the eighth grade or lower. Monthly payments can be made by check or automatic transfer. In addition, state employees and employees from some other organizations can arrange to pay through payroll deductions.

The enrollment period is from mid-October through mid-January. Purchasers must pay a nonrefundable $42 application fee per child. Applications may be submitted to the program office or to any branch of First Union National Bank, the approved agent for distributing information on the program.

Price Structure

The costs of prepaid tuition and dormitory contracts vary by the benefit plan selected and the age of the beneficiary. Following are some examples that show the range of costs in 1993-94.

- Under the 4-year university plan, the lump-sum payment was $5,879 for an eleventh grader and $5,639 for a newborn; the monthly payments were $328 and $47, respectively. Under the 5-year installment plan, payments were $125 for an eighth grader and $121 for a newborn.

- Under the 2-year community college plan, the lump-sum payment was $2,065 for an eleventh grader and $1,328 for a newborn; the monthly payments were $115 and $11, respectively. The 5-year installment plan payments were $41 for an eighth grader and $29 for a newborn.
- Under the community college/university plan, the lump-sum payment was $4,983 for an eleventh grader and $4,127 for a newborn; the monthly payments were $278 and $35, respectively. The 5-year installment plan payments were $103 for an eighth grader and $89 for a newborn.
- For a 1-year dormitory contract, the lump-sum payment was $2,002 for an eighth grader and $1,589 for a newborn; the monthly payments were $43 and $14, respectively; and the 5-year installment plan payments were $43 and $35, respectively.
- For a 4-year dormitory contract, the lump-sum payment was $7,755 for an eighth grader and $6,156 for a newborn; the monthly payments were $166 and $51, respectively; and the 5-year installment plan payments were $166 and $132, respectively.

The tuition prices quoted reflect an average 6.5-percent surcharge over the 1993 tuition rates to ensure that the payments would meet future tuition costs. The cost of prepaid dormitory contracts is based on a weighted average of dormitory rates throughout the state university system.

Redeeming Prepaid Benefits

The beneficiary can begin using benefits up to 3 years in advance of the expected date of enrollment specified on the contract as long as the contract is paid in full. Benefits can be used for up to 10 years after the anticipated date of enrollment. Also, the time frame can be expanded an additional 10 years upon request, for an additional fee. Any time spent on active duty in the U.S. armed services will be added to the time frames for using tuition and housing benefits. Also, students can attend part time, spreading out their tuition credit hours over more than 4 years. In addition, beneficiaries always qualify for resident status tuition, even if they move out of Florida after the contract is purchased.

Program Flexibility

Purchasers are allowed to change their benefit plan while still making payments, in some cases even after the beneficiary starts college. For example, if a student with a prepaid contract for the 4-year university plan decides to enroll in a community college instead, the benefits will be used to pay the lower tuition rate, and the purchaser will be given a refund of the difference, which can be used to pay for other educational expenses.

Also, if a student with a prepaid contract for the community college plan transfers to a state university after 1 year, the student's remaining benefits will be applied toward tuition at the university. The conversion calculations are based upon the tuition rates at the time of enrollment. Any unmet costs will be the responsibility of the student.

If the beneficiary gets a scholarship, the purchaser will get a refund with interest for each semester covered by the scholarship.

Contracts may be used at any in-state private or out-of-state, not-for-profit institution that confers baccalaureate degrees. If a beneficiary attends a private in-state institution, the program will pay the school the amount equal to the cost of public tuition at the time of enrollment. If a beneficiary attends an out-of-state institution, the program will pay the school an amount equaling the value of Florida public tuition at time of enrollment or the original purchase price plus 5 percent interest compounded annually, whichever is less.

Purchasers may elect to terminate a contract at any time. If the purchaser terminates a contract because a beneficiary dies or becomes disabled prior to enrolling in college, the purchaser will get a refund equal to the amount paid into the plan plus 5 percent compounded interest or the current in-state tuition rate, whichever is less.

When contracts are terminated for other reasons, refunds are typically for the amount paid into the plan minus administrative fees; no interest is refunded. For instance, if a beneficiary leaves school (whether voluntarily or not) before completing all the semester hours paid for in the contract, the purchaser will receive a refund of the remaining benefits, minus an administrative fee of $50 or 50 percent of all money paid, whichever is less. However, this refund will not include payments for the remainder of any semester in which the student was enrolled. Also, if a contract for the 4-year university plan is terminated after a student completes an Associate of Arts degree, but the student decides not to pursue further education, the $50 cancellation fee will not be assessed.

If a contract held 2 years or less is terminated because of default or purchaser's decision to voluntarily cancel the contract, the refund will equal the total of all money paid into the plan minus an administrative fee of the lesser of $50 or 50 percent of all money paid, and any outstanding late fees. For contracts held more than 2 years before termination by election or default, no administrative fee is subtracted from the refund.

The purchaser can change the beneficiary named on a contract so long as (1) the new beneficiary is a sibling, half-sibling, or step-sibling of the original beneficiary; (2) the new beneficiary meets the requirements of a designated beneficiary at the time of the substitution; and (3) the substitution is made before the original beneficiary enrolls in college. The purchaser must pay a $5 fee for substituting beneficiaries. Additionally, if the new beneficiary is expected to enroll in college more than 3 years before the original beneficiary, the purchaser also must pay a sum to ensure the actuarial soundness of the program.

The program can terminate a contract if the program finds that the purchaser made fraudulent statements relating to the beneficiary's residency. If this happens, the purchaser gets a refund of all remaining money paid into the fund after charging a termination fee. The program will charge either 100 percent of money paid into the plan or $250, whichever is less.

Additional Features

Florida's program offers a life insurance plan, underwritten by North American Life Assurance Company, that ensures purchasers that contract payments will be completed in the event of their death. A prepaid contract purchaser must be under age 65 to qualify for the life insurance policy. To acquire coverage, contract purchasers fill in a special section on the basic program application. The cost of the annual insurance premium depends on the contract payment plan, the benefits purchased, and the age of the purchaser. During the 1993-94 enrollment period, the annual premiums ranged from $10 for a person under 35 purchasing a community college contract under the 5-year installment plan to $225 for a person aged 50 to 65 purchasing a university contract plus 4 years of housing under the monthly payment plan. The insurance and annual premium payments continue until the purchaser either makes the final contract payment or turns 75, regardless of whether all contract payments have been made, whichever comes first. If a purchaser is ever more than 30 days late with an insurance premium, the insurance will end. Also, the purchaser can cancel the insurance at any time.

Michigan

Michigan enacted the Michigan Education Trust program in 1986. The program, which first sold contracts in the fall of 1988, provides for the prepayment of undergraduate tuition and fees at any of Michigan's 15 public universities and 29 community colleges. Although contract sales were halted after the 1990 enrollment period, the program still invests the money it received and honors contracts it sold. The program is administered by the state Treasury Department.

Educational Benefits

Participants could choose from three benefit plans—full benefits, limited benefits, and community college. The full benefits plan guaranteed to cover in-state tuition and fees at any 4-year public college or in-district tuition and fees at any 2-year public college. The limited benefits plan guaranteed to cover tuition and fees only at any public colleges whose tuition costs did not exceed 105 percent of the weighted average tuition cost of Michigan's 4-year institutions. Finally, the community college plan covered in-district tuition and fees at any of Michigan's 29 community colleges. Under the full and limited benefits plans, individuals could purchase contracts for 1, 2, 3, or 4 years; under the community college benefit plan, individuals could purchase contracts for 1 or 2 years.

Enrollment Process

Michigan's program had a limited enrollment period during the fall. At the time of enrollment, purchasers had to pay $85 in nonrefundable application and processing fees and specify the beneficiary and a refund recipient, in case the benefits were not used by the beneficiary. At the time of purchase,.the beneficiary had to be a Michigan resident, and the purchaser had to be a U.S. resident. Purchasers did not have to be related to the beneficiary.

The program allowed businesses, as well as individuals, to purchase contracts. Only one person could be named as the contract purchaser. However, a beneficiary could be named on more than one contract. For example, a parent and grandparent could each buy a 2-year full benefits plan contract for the same child.

In its first 2 years of operation, purchasers had to make lump sum purchases for all contracts. In 1990, however, purchasers could use one of three monthly payment options to purchase contracts. Monthly payments could be spread over 4, 7, or 10 years from the purchase date, depending on how soon the beneficiary was expected to enroll in college. Purchasers could not use the monthly payment option if beneficiaries were past a certain age or grade in school. In addition, purchasers could only use monthly payment options when purchasing full benefits or community college plans. Payments could be made through payroll deductions, direct debit, electronic funds transfer, or with personal checks.

During all 3 years that contracts were sold, purchasers could also finance a lump-sum purchase through secured loans available from Michigan savings and loan institutions. If borrowers defaulted on these loans, the program would pay off the lending institution from the value of the contract. The terms of the loans varied by institution.[48] The fee for processing defaults on secured loans was $50.

Price Structure

The cost of contracts depended on a number of factors, including the beneficiary's age or grade in school, and the benefit plan and payment option chosen. In 1990, under the full benefits plan, 4 years of tuition cost $15,496 for an eleventh or twelfth grade student, which represented the current cost of tuition and fees for the highest-priced public university in the state. Contract prices decreased along with the beneficiary's age. For instance, the same plan cost $9,296 for a child in kindergarten. Prices also varied by the chosen payment option. For example, if a purchaser chose a monthly payment plan to pay for 4 years of tuition and fees for a second grader, payments would be $130 a month for 10 years, $164 a month for 7 years, or $252 a month for 4 years.

Redeeming Prepaid Benefits

Beneficiaries must notify the program when they are ready to start college. The program will then pay the tuition each year as the student enrolls. If beneficiaries do not meet residency requirements for a Michigan school at the time of enrollment, they are responsible for paying the additional charges of the nonresident tuition rate. Students can use their tuition benefits up to 9 years after they are scheduled to begin college.

Program Flexibility

Beneficiaries may voluntarily terminate their contracts and get a refund for a variety of reasons. They may also transfer contracts under certain circumstances. Furthermore, the program makes allowances for purchasers who stop making payments or who default on loans to use benefits they have paid for.

Refund amounts vary depending on the reason for terminating the contract, but they will never be less than the contract amount paid to the program. In most cases refunds are not available until the beneficiary reaches college age. Under the full benefits plan, refund rules are as follows:

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[48] We spoke with officials at three of the institutions that made these loans. We found that, in general, purchasers had up to 15 years to repay the loans, depending on the age of the child. The loan rates ranged from about 8.75 percent to 12.5 percent.

- If the beneficiary receives a full scholarship, the average tuition cost of Michigan's 4-year public institutions will be paid to the refund designee in four annual installments.
- If the beneficiary decides to attend a private institution in Michigan, the weighted average tuition cost of Michigan's 4-year public institutions will be paid to the beneficiary's chosen school, or the lowest tuition at Michigan 4-year public institutions will be paid to the refund designee.
- If the beneficiary decides to attend an out-of-state college, the average tuition cost of Michigan's 4-year public institutions will be paid to the beneficiary's chosen school in four annual installments.
- If the beneficiary does not plan to attend any higher education institution, the program will pay to the refund designee the lowest tuition of Michigan's 4-year public institutions, in four annual installments.
- If the beneficiary dies or becomes disabled, the program will pay the refund designee a lump sum equal to the lowest tuition of Michigan's 4-year public institutions.
- If a refund request for any other reason is approved, the program will pay the refund designee the lowest tuition of Michigan's 4-year public institutions, in four annual installments.

In all these cases, except when the beneficiary attends an in-state private college or in cases of death or disability, refunds will be reduced by a $200 termination fee.

Refunds may not be available in certain circumstances. The most significant restriction is that beneficiaries may not terminate their contracts for a refund after they have completed more than half the credit hours necessary to receive a 4-year baccalaureate degree, even if they have not used the contract benefits to pay for college. However, this restriction does not apply to graduates of Michigan community colleges who terminate their contracts before enrolling in a 4-year state institution. Beneficiaries may also lose their right to a refund if they state fraudulent information in their contracts or do not use their benefits within the 9-year time period after the expected date of college enrollment.

Beneficiaries who are 18 years or older may transfer their contracts to another beneficiary in their immediate family or the purchaser's immediate family. Contracts transferred to an older person, or one in a higher grade than the original beneficiary, will require an additional payment to the program. Contracts may also be transferred if the beneficiary dies or becomes disabled, or if the beneficiary receives a full tuition scholarship. However, benefits cannot be transferred after more than half the benefits have been used toward a 4-year degree. The fee for transferring the contract to a new beneficiary is $25.

If purchasers using a monthly payment option stop making payments, they are not terminated from the program. Instead, they receive the educational benefits they paid for. If they want to purchase additional educational benefits in the future, they can do so at the new cost. Similarly, if a purchaser defaults on a secured loan, he or she still can get any educational benefits remaining after the program pays the savings institution the outstanding loan amount.

Ohio

In 1989, Ohio created the Ohio Tuition Trust Authority, a state agency specifically established to operate the Prepaid Tuition Program. The program began selling tuition credits at the end of that year for undergraduate education at Ohio's 13 public universities and 23 community colleges. The program is backed by the full faith and credit of the state.

Educational Benefits

Participants purchase tuition credits. Each credit is worth 1 percent of the weighted average cost of full-time tuition and fees for 1 year at Ohio's public universities. Therefore, at a 4-year institution, 100 credits would cover a student's tuition and fees for 1 year, and 400 credits would cover 4 years' worth. At a community college, 100 tuition credits would cover 2 years' worth of tuition. Students can attend full or part time.

Enrollment Process

Purchasers may enroll throughout the year. They must purchase at least one tuition credit and pay a nonrefundable $50 enrollment fee. There are no residency, relationship, or age requirements for purchasers, although those under age 18 must have the signature of a legal guardian. Beneficiaries must be residents when their account is established and must have a social security number. The program allows only one purchaser per account, but other individuals may contribute. Purchasers may start multiple accounts for multiple beneficiaries. Likewise, beneficiaries may be named on more than one account.

When an account is opened, the purchaser must specify (1) whether the purchaser or the beneficiary will receive the refund if credits are not used, (2) whether the purchaser's consent is required to terminate the contract, and (3) whether the purchaser's consent is required to transfer some or all credits to a new beneficiary.

The program allows purchasers to make payments by check at any time, using coupons provided by the program. Purchasers can also make payments through payroll deduction or automatic transfers from checking or savings accounts. However, the program requires monthly minimum payments of $25 per contract for transactions made through payroll deduction or automatic transfers.

The program also has offered various purchase plans that allow participants to meet different savings goals. For example, the "Helping Hand Package" encourages people to save $50 per month over many years; the "Semester Package" encourages people to save $180 per month over 1 year to prepay one semester of tuition. However, none of these packages requires people to adhere to the payment schedule—all payments are optional. Purchasers receive semiannual account statements to give them an update of their status.

Price Structure

The program sets prices each August for the following year based on the annual weighted average of tuition and fees at Ohio's 4-year public institutions. In addition, the prices reflect a premium to ensure that the payments meet future tuition and administrative costs. In 1994-95, the weighted average tuition was $3,455, but the program charged $3,750, or $37.50 per credit, based on this adjustment. Thus, the lump-sum cost of 4 years of tuition was $15,000.

Redeeming Prepaid Benefits

Beneficiaries may redeem tuition credits 2 years after purchase. If beneficiaries are not state residents when they start college, they may have to pay the difference between the resident and nonresident tuition rates if they return to Ohio to attend college.

Program Flexibility

Beneficiaries who attend a state institution with tuition lower than the weighted average may need fewer than 100 credits per year for tuition and can spread their credits to cover more than 4 years of school. Beneficiaries who attend a state institution with tuition higher than the weighted average may need more than 100 credits per year for tuition.

The program allows credits to be used at nonparticipating institutions. For instance, if a beneficiary goes to a private or out-of-state school, the program will pay the school the weighted average tuition of the Ohio public colleges and universities at the time. The beneficiary would be expected to pay any remaining costs.

Unused benefits can be refunded or transferred. Only beneficiaries may request a refund or transfer of credits when they reach college age. Credits cannot be refunded until the beneficiary is 18 years old and the credits are mature (on account for 2 years or more). Further, funds cannot be withdrawn before the beneficiary reaches college age, except in cases of death or permanent disability. Following are some of the conditions in which refunds apply, and their amounts.

- If a beneficiary receives a merit-based scholarship, the program will either (1) pay to the beneficiary, through the academic institution, an amount equal to the value of his or her credits; or (2) refund 99 percent of the current weighted average tuition after the student graduates.
- If a beneficiary dies or becomes disabled, the program will pay the refund recipient the greater of the current weighted average tuition or the purchase price.
- If a beneficiary graduates before all the tuition credits are redeemed, the credits can be used for graduate or professional studies, or they can be refunded at 99 percent of weighted average tuition.
- If a beneficiary requests a refund—either because he or she does not want to go to college or has started but wants to stop—the program delays any refund for 1 year to allow the beneficiary to reevaluate the decision. Then, if the beneficiary decides not to attend or finish college, the program will pay the refund recipient a maximum of 100 credits per year until all credits are paid, minus a $25 termination fee per year. The value of the credits refunded is equal to 99 percent of the current weighted average tuition. If the beneficiary decides to start or return to college, the program will stop the refunds, and the remaining credits can be used.

In any of these cases in which a refund might apply, a beneficiary may choose to transfer any unused credits to a new beneficiary. The new beneficiary must be an Ohio resident and an immediate family member. The program charges $25 for transferring credits to a new beneficiary.

After a beneficiary reaches college age, if there are no more payments into an account or credits redeemed for 10 years, the program may terminate the contract and keep the funds. The program also may terminate a contract if it finds that fraudulent information has been reported about the purchaser or beneficiary.

The state also reserves the right to terminate the program, cancelling contracts and providing refunds.

Pennsylvania

Since the fall of 1993, the Pennsylvania Tuition Account Program has offered tuition credits for use at Pennsylvania's public colleges and universities. Pennsylvania has 14 community colleges; 14 universities that compose the state system of higher education; and 4 state-related universities, which include Pennsylvania State, Temple, Pittsburgh, and Lincoln. The state's Treasury Department administers the program, which was enacted in April 1992.

Educational Benefits

Participants in the Pennsylvania Tuition Account Program purchase tuition credits that can be redeemed toward tuition and mandatory fees of undergraduate study at public colleges and universities in the state. At 4-year institutions, each tuition credit equals one twenty-fourth of an academic year of tuition for full-time students. Thus, if attending as a full-time student, beneficiaries would need 96 credits to cover 4 years of study. At community colleges, each tuition credit equals 1 credit hour. Community colleges require 15 credit hours per semester; therefore, a full-time student would need to have 60 credits for the 2 years of study required for an associate degree.

Participants can also purchase even smaller amounts, known as tuition units, for use at 4-year and 2-year institutions. Each tuition unit equals one-twentieth of a tuition credit.

In addition, purchasers have the option of purchasing credits or units for a specific institution, or for one of the three standard tuition categories—community colleges, state system of higher education, or state-related institutions. The standard tuition category is the approximate average tuition for 1 year's tuition at all the schools within a given tuition category. Purchasers who are unsure of the specific school the beneficiary will attend, but certain of the type of school they will attend, might choose this option. Purchasers receive an annual account statement showing the total number of tuition credits purchased.

Enrollment Process

Either the purchaser or the designated beneficiary must be a state resident when the purchaser applies to the program. Purchasers must be at least 18 years old, and they may designate themselves as beneficiary. They may also designate the beneficiary as "unnamed" if the credits will be used as part of a scholarship program approved by the program. In addition, any legal entity can also be a purchaser, enabling clubs and other organizations to establish accounts for either specified or unspecified beneficiaries. While joint ownership of an agreement is not allowed, beneficiaries can be named on multiple agreements. Also, someone other than the purchaser may contribute toward the account.

When applying, purchasers must designate the beneficiary's anticipated date of college enrollment. They must also purchase at least one tuition unit. Purchasers pay a $65 nonrefundable application fee when applying to the program. Program enrollment takes place throughout the year, but new prices go into effect each year on September 1.

Purchasers may choose one of several payment methods, including personal check, direct transfer from their bank account, and payroll deduction. The program will change the payment method at any time for a $1 fee, upon written request of the purchaser. Purchasers may make either one lump-sum payment or send in payments whenever they want using coupons provided by the program.

Benefits may be purchased at either the resident or nonresident rate, depending on the beneficiary's residency at the time of application or the residency status anticipated at the time the beneficiary enrolls in college.

Pricing Structure

The price of benefits varies by institution, tuition category, campus location, residency, and course of study. For example, at Pennsylvania State University, tuition credits for the main campus and two other campuses are the same, but for all other branches prices are slightly different. Similarly, at the University of Pittsburgh main campus, tuition credits for studying engineering or nursing cost more than credits for studying arts and science or social work. Community colleges also have a tuition credit price for students who are state residents but live outside of the district of the community college that they will attend.

Prices are based on current tuition prices, plus a premium based largely on tuition trends at specific schools over a 20-year period. The premium for credits at schools where tuition has increased dramatically in recent years is likely to be higher than for schools where tuition increases have been more moderate. The premium is intended to guarantee that the credits will be of sufficient value when they are needed. Premiums are set by an actuarial firm.

Following are some specific prices that were in effect from September 1, 1994, to August 31, 1995:

- For community colleges, the lowest price of a tuition credit was $50 for an in-district resident at Westmoreland Area Community College; the highest price was $215 for an out-of-state student at Bucks County Community College. The standard tuition price was $64 for residents, $121 for out-of-district students, and $175 for out-of-state students. This translates to $960, $1,815, and $2,625 per semester, respectively.
- Tuition credit prices at all universities in the state system of higher education were the same—$129 for residents and $328 for nonresidents; this translates to $1,548 and $3,936 per semester, respectively.
- At state-related universities, the tuition credit price ranged from $126 for state residents at Lincoln University to $670 for nonresidents in the pharmacy program at Pittsburgh. The standard tuition price per credit was $233 for residents and $480 for nonresidents, translating to $2,796 and $5,760, respectively, per semester.

In all cases, a tuition unit is one-twentieth the cost of a tuition credit.

Redeeming Prepaid Benefits

Tuition credits (and units) must be 4 years old before they can be used. Beneficiaries must begin using their benefits within 5 years of their projected enrollment date specified on the application. The program will extend the start date an additional 5 years, although in such cases, the program may require an assessment fee to ensure that the tuition account will meet the tuition costs at the time of use. Time spent on active duty in the U.S. armed services does not count toward the 5-year period for beginning to use tuition credits. All credits must be redeemed within 10 years after the beneficiary first enrolls in college. Time spent on active duty will be added to this 10-year period.

To use the credits, the purchaser or the beneficiary must write to the program to request a certified statement of accumulated tuition credits. The letter must include the name of the institution to be attended, the amount of any scholarship awards, the number of the account as it appears on the agreement, and the institution's tuition rate.

Next, the program will convert credits if changes occur in the selection of a specific institution or the category of institutions. The conversion is an adjustment between what has been purchased and what the credits will actually be used for. For instance, the program will convert credits if a beneficiary changes from one institution to another. Also, if payments were made for a standard tuition category, the program will convert the credits once the student selects a specific school. The conversion also takes place for changes in residency. In these cases, the student may end up with more than enough credits or not enough credits, depending on what was originally purchased and how the credits were later used. Beneficiaries who do not have enough credits will be expected to pay any remaining costs. Beneficiaries with excess credits can apply them toward a master's degree or some other postbaccalaureate program. Also, if the student decides to attend college on a part-time rather than full-time basis, the cost may be greater per credit hour. In this case, the program will also convert the value of the account to the part-time equivalent.

After the conversion is made, the program will send the certificate to the purchaser or beneficiary. The purchaser or beneficiary must then forward the certificate to the institution. The institution will return the certificate to the program with a letter certifying that the student has been accepted for that academic year.

The value of prepaid benefits does not affect eligibility for state-based financial aid. If the beneficiary gets a scholarship at either a participating or nonparticipating institution, a refund will be given for the benefits covered by the award in the amount of either the tuition for the number and type of the tuition credits purchased or the value of the account, whichever is less. However, such refunds for a given academic award will not exceed the amount of the scholarship for that year.

Program Flexibility

Tuition credits may be applied toward the cost of tuition at nonparticipating institutions, which include private in-state or any out-of-state schools meeting certain accreditation standards. However, tuition credits are not guaranteed to cover the student's tuition at a nonparticipating institution. Tuition credits may be redeemed for a nonparticipating institution once the beneficiary or purchaser submits to the program an invoice for tuition at the institution. The program will then pay the institution the lesser of (1) the amount of the invoice, (2) the actual tuition for the number and type of credits purchased, or (3) the full value of the account, which is all money paid for credits or units plus a pro rata share of fund earnings. Any remaining costs must be paid by the student.

If the beneficiary decides not to go to college, the purchaser can exercise one of two options—designate a substitute beneficiary or request a refund. If a substitute beneficiary is chosen, the substitute must be a family member of the purchaser or the original beneficiary, and must meet residency requirements if the purchaser is not a state resident. If the purchaser requests a refund, the program pays the purchaser either 90 percent of the tuition for the number and type of the tuition credits purchased or 90 percent of the value of the account, whichever is less.

If the purchaser chooses to withdraw from the program for any other reason, the purchaser receives the lesser of (1) 90 percent of the tuition for the number and type of the tuition credits purchased, (2) 90 percent of the value of the account, or (3) all money paid toward tuition credits or units.

If the beneficiary dies or becomes disabled, or if the beneficiary fails to gain admittance into college, the program pays the purchaser the value of the account. If the beneficiary fails to redeem all credits within the appropriate time frames, the program will terminate the agreement. In this case, the program will pay the purchaser either 90 percent of the tuition for the number and type of the tuition credits purchased or 90 percent of the value of the account, whichever is less.

Purchasers may transfer agreement ownership to a new purchaser, as long as the new purchaser is a family member of the current owner and meets residency requirements if the beneficiary is not a state resident. In addition, transfers must be made without consideration; that is, benefits cannot be sold or traded.

Wyoming

Under the Advanced Payment of Higher Education Costs Program, contracts are sold for undergraduate education at the University of Wyoming or any community college in the state. The program was established in 1987, and contracts first went on sale that summer. The program is administered under the auspices of the University of Wyoming Board of Trustees.

Educational Benefits

The program allows people to prepay the costs of tuition and fees only, or tuition, fees, and room and board. Purchasers can buy contracts for 2 years at a community college, and 1 to 4 years at the University. The program offers contracts for both residents and nonresidents.

Enrollment Process

Contract purchasers need not be state residents, and they can purchase multiple contracts. Enrollment takes place throughout the year. However, each year the program establishes new prices that are only in effect from August 1 through August 15. The program adds 10 percent annual interest to purchases after that date. No application fee is charged.

Price Structure

Costs vary dramatically depending on which benefit package is chosen, when the beneficiary will enroll, and the beneficiary's residency. For example, as of August 1993, the least expensive benefit plan was $3,763 for tuition and fees for 2 years of community college beginning in 2013. For a resident enrolling in 2002 for 4 years at the University, a contract covering tuition, fees, and room and board was priced at $43,766. For a nonresident, that same contract would have cost $122,847.

Purchasers may make lump-sum payments with cash; money orders; or personal, cashier's, or registered checks. They may also finance their purchase through a secured loan offered by various Wyoming banks, savings and loans institutions, and credit unions.[49] If the purchaser fails to make payments, the University reimburses the unpaid amount to the lending institution. At that point, the contract will be terminated and the program will refund the purchaser any funds that remain after settling the default.

Redeeming Prepaid Benefits

Beneficiaries have 6 years from the anticipated college enrollment date to use the benefits. The beneficiary's residency status at the time of admission is determined by the school, regardless of the status when applying to the program. Beneficiaries who have contracts for in-state tuition but are deemed nonresidents by their school must pay for the additional costs. Likewise, beneficiaries who qualify for in-state tuition but have nonresident contracts can use the additional funds for other educational expenses.

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[49] We spoke with a loan officer at one of the lending institutions and found out that purchasers have 10 years to pay back the loan at a fixed rate, including a 5-year balloon payment. As of January 1995, that rate was 8 percent. If the purchaser has good credit at the end of the first 5 years, the loan balance can be refinanced for the remaining term at the existing loan rate.

Program Flexibility

Purchasers can cancel their contract and receive a refund if the beneficiary dies, attends a nonparticipating institution, is not admitted to college after properly applying, decides not to attend college, or elects not to use the benefits and a substitute beneficiary is not named.

The amount of the refund depends on whether benefits have been used yet. If the purchaser cancels the contract before any benefits have been used, the program will refund the advance payment plus 4 percent interest compounded annually. If the purchaser cancels the contract after some benefits have been used, the program will refund the advance payment plus 4 percent interest compounded annually, minus any benefits used.

A substitute beneficiary may be named at any time to take advantage of any unused benefits.

Additional Problems States May Encounter in Establishing and Operating a Tuition Prepayment Program

In addition to unresolved federal tax questions (discussed in ch. 4), officials identified a variety of other problems or barriers that states may face in setting up and running a tuition prepayment program. Three of the problems they emphasized most included (1) developing actuarial assumptions that accurately reflect trends in college costs and investment returns, (2) encountering opposition from various public and private interests, and (3) working out the administrative details involved in daily program operation. Knowledge of these problems, and how they have been dealt with, may be instructive to state officials who are interested in starting such a program in the future.

Making Accurate Actuarial Assumptions

One problem that some officials identified has to do with the accuracy of key actuarial assumptions: problems can arise for these programs when tuition rates increase faster than expected or investments earn a lower return than expected. Two officials described how the years preceding the start of their programs turned out not to be a good predictor of tuition and interest rates in the years after the programs began. The economic landscape changed, one official explained; state revenues decreased, which led to pressures to increase tuition rates faster than anticipated, and at the same time interest rates declined. Rising tuition rates seemed particularly vexing to two officials we interviewed. How can state universities justify an 11-percent tuition increase, one asked rhetorically, in a year when the general inflation rate is 3 percent?

Two officials who described being somewhat disappointed with the rate of return they have received on their investments said they may begin to invest more aggressively in equities. Unexpectedly large tuition increases, however, have not proven an easy problem for officials to deal with. One director described raising the prices for program benefits, but said that the program may now be too expensive for many people to afford. Another official said it would be easier to operate the program if the state had some central control over colleges' tuition rates.

Encountering Opposition From Various Sources

Another barrier some officials described is opposition from a variety of sources, particularly when the program is initially under consideration, but also during its operation. For example, state politicians can raise concerns about the potential for the program to create an unfunded liability for the state; public higher education officials may worry that the program will lead to a cap on tuition prices or a reduction in their funding, making it harder for colleges to cover their expenses; private college representatives may raise the issue of student choice and the possibility of declining enrollments at their institutions; and members of the banking and investment industry may argue that a state program allowing families to prepay the cost of college will take away business from the private sector.

The ability of program proponents to overcome this type of opposition is obviously important to their ultimate success. Following are some examples of the strategies program officials have used.

- To deal with the potential opposition from public colleges, one official described having several meetings with college representatives early in the developmental stage to explain how the program would work and correct any misperceptions they might have had about the program's implications. College officials were also invited to participate in drafting the authorizing legislation. Giving top officials from the state's higher education system a seat on the board overseeing the prepayment program can also help ease their fears, some officials reported.
- To deal with opposition from banks, insurance companies, and other private sector firms, one program director has described the importance of emphasizing the noncompetitive aspects of tuition prepayment programs. "For example, advertising should stress the guarantee of payment of future tuition, rather than any perceived rate of return on the premiums paid."[50] Another step programs can take is to give the private sector some of the business, by contracting out for services such as sales, marketing, and records administration.

Resolving Administrative Details

An additional challenge for some states has been working out the administrative details of implementing and operating the programs. Numerous decisions must be made, such as what part of the operation, if any, should be contracted out versus handled in-house. Officials must develop the program rules; consult with attorneys, actuaries, and investment advisors; and hire staff with the skills needed to operate the program. Records administration posed a particularly difficult challenge for two programs: officials described having to develop customized computer systems to keep track of purchasers' accounts because there were no adequate systems commercially available.

In resolving these kinds of problems, officials in different states have made different decisions. For example, officials in Ohio decided to run the tuition prepayment program entirely in-house with about 17 full-time staff members. In contrast, Florida has only eight full-time staff and contracts out for almost all its services. Officials in two states mentioned that in setting up and running their programs, they have benefitted from the expertise of staff in the state treasury department. Finally, a few officials mentioned the value of talking with their colleagues in other states where these programs were already in place and learning from their experiences.

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[50] William Montjoy, "State Prepaid Tuition Plans: Designing a Successful Program," Prepaid College Tuition Plans: Promise and Problems, ed. Michael A. Olivas (New York: College Entrance Examination Board, 1993), p. 47.

Federal Taxation a Major Issue Facing State Tuition Prepayment Programs

The most serious issue facing state tuition prepayment programs is the potential applicability of federal tax provisions. Two potential taxes are particularly troubling to program officials: (1) a tax on program investment earnings, because that would make it more difficult for programs to meet their future liabilities, and (2) an annual tax on participants, because that would be unappealing to purchasers and an administrative burden, according to program officials. Uncertainty about federal taxes began with Michigan's pioneering program and persists to this day. Moreover, because of the negative impact such taxes can have on these programs, some states have decided to delay program implementation and others have backed away from the concept altogether. Favorable resolution of these issues would help existing programs to succeed and stimulate renewed interest in these programs among other states.

Michigan's History of Tax Problems

Federal taxation has been an important issue since Michigan established the first state tuition prepayment program, the Michigan Education Trust (MET). The statute creating MET required that before the program could sell any contracts, it had to obtain a ruling from IRS that purchasers would not be subject to federal income taxes on the benefits they purchased or on the program's investment earnings. MET requested a private letter ruling[51] in February 1987. IRS ruled in March 1988 that (1) purchasers may be liable for the federal gift tax, (2) beneficiaries would be required to pay federal income taxes on the increased value of their benefits at the time of redemption, and (3) MET itself would have to pay federal taxes on its investment earnings.

On the third point, MET had argued in its ruling request that its investment earnings were exempt from federal taxation primarily because it was an "integral part of the state" and traditionally the federal government does not tax the direct income of states.[52] In its ruling, however, IRS concluded that MET was not an integral part of the state, essentially because (1) it was created as a corporation to operate independently from the state, under an appointed board of directors whose decisions could not be overridden by the state, and (2) its funds did not come from the state or one of its political subdivisions, were not available to state creditors, and could not be used by the state for any purpose.[53]

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[51] As explained in an IRS publication, "A 'letter ruling' is a written statement issued to a taxpayer" by the national office of IRS "that interprets and applies the tax laws to the taxpayer's specific set of facts." See Revenue Procedure 95-1, Department of the Treasury, IRS, Publication 1375 (Rev. 1-95), p. 7.

[52] Alternatively, MET argued, its investment earnings could be excluded from gross income under section 115 of the Internal Revenue Code, which provides that gross income does not include income derived from the exercise of any essential government function and accruing to a state or any political subdivision thereof.

Although some observers saw the ruling as unfavorable—because of the requirement that MET pay taxes on its investment earnings—the ruling satisfied Michigan's statutory requirements, and the program began selling prepaid tuition contracts in the fall of 1988. In compliance with the letter ruling, MET paid $15.8 million in corporate taxes for its first 3 years of operation. In 1991, however, lower investment returns made it more difficult to stay ahead of tuition inflation while also paying the required federal taxes. Therefore, MET suspended new contract sales and requested a full tax refund. When IRS denied the refund request, MET and the state of Michigan sued the United States, arguing that the program's investment earnings were exempt from federal taxes because it was an integral part of the state or, if not on that basis, then for other reasons.[54]

MET lost the case in U.S. district court in July 1992 but won its appeal in the Sixth Circuit Court of Appeals in November 1994. The Circuit Court concluded that MET is an integral part, as well as a political subdivision, of the state and therefore tax exempt; IRS was ordered to refund all corporate taxes MET had paid over the years (now totaling more than $60 million), with interest. IRS, concerned that the decision was too broadly reasoned and could have significant administrative implications for its operations, requested a rehearing of the case in the Circuit Court, but was denied. Subsequently, the Solicitor General decided not to appeal the Circuit Court's decision to the U.S. Supreme Court.

Tax on Investment Earnings a Major Concern for Prepayment Programs

IRS's ruling on MET, along with the subsequent district court decision, heightened the concerns of officials in other states about whether and how tuition prepayment programs would be taxed. For these programs to survive and proliferate, one official said, it is critical that their investment earnings not be subject to federal taxation. In response to this concern, some states have delayed plans to implement tuition prepayment programs; others decided against implementation, choosing instead to issue college savings bonds as an alternative way to help families save for college; and some states implemented their programs, although trying in various ways to avoid some of the problems Michigan encountered.

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[53] The ruling also concluded that even if MET were a political subdivision of the state, it still would not have qualified for an exemption under section 115 because its income mainly served the private interests of particular individuals, rather than the public interest of the community in general. Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988).

[54] Michigan and MET also argued that the program's investment earnings were exempt from federal taxation under (1) section 115 of the Internal Revenue Code, as discussed earlier; (2) sections 501(c)(3) and (c)(4) of the Code, pertaining to tax exempt organizations; (3) the doctrine of intergovernmental tax immunity; (4) the tenth amendment of the U.S. Constitution, which reserves to the states powers not prohibited to them nor delegated to the federal government; and (5) the Guarantee Clause of the Constitution, which guarantees to every state a republican form of government.

Some States Defer Action Because of Concerns About Taxation

IRS's decision to tax MET's investment earnings was troubling news to states interested in tuition prepayment programs. Paying such taxes makes it more difficult to meet future liabilities without setting benefit prices prohibitively high. After the MET ruling, several states that had been interested in starting tuition prepayment programs backed away from the idea, discouraged by the prospect of getting a similar ruling. Among these states, according to various written accounts, were Maine, Missouri, Oklahoma, Tennessee, and West Virginia. In Virginia, 1994 legislation authorizing a tuition prepayment program stipulated that the program cannot begin selling contracts until IRS rules that the program's investment earnings are exempt from federal taxation.

Indiana also indefinitely postponed implementation of a tuition prepayment program, after receiving its own letter ruling from IRS in September 1988. Although it was much less publicized, the ruling was similar to Michigan's, concluding that Indiana's proposed program would be subject to federal taxes on its investment earnings. Given the corporate tax rate the program would have faced, earning investment returns sufficient to cover future liabilities would have been difficult, according to one Indiana official. "We didn't feel that we could keep up with tuition costs that are rising about 9 percent a year. We would have to earn a return of around 13 percent before taxes to get 9 percent after taxes."[55]

Officials Focus on Making Programs Integral Part of State

In light of Michigan's experience, other states that have started tuition prepayment programs have tried to structure them more clearly as an integral part of the state. Alabama and Pennsylvania, for example, tried to make a stronger link between the program and the state by placing the program within and under the direct control of the treasury department. Alaska and Wyoming established their programs within the state's higher education system. Alaska's program Director reasoned that since the University of Alaska, which offers the program, is exempt from federal taxes as an instrumentality of the state, this exemption should apply to the tuition prepayment program.

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[55] Cited in Jacqueline Mitchell, "Michigan Flunks Its Tuition Trust Fund," Wall Street Journal (Mar. 26, 1992), p. C16.

Another step states can take to help protect their programs' investment earnings from federal taxation is to back the program with the full faith and credit of the state. Thus far, IRS has emphasized this as a significant factor toward gaining recognition as an integral part of the state, because it clearly demonstrates the state's financial stake in the program. However, Florida's program is the only one to operate with the full faith and credit of the state from its inception. By statute, in the event of a shortfall the legislature must appropriate to the program sufficient funds to enable it to meet its obligations to qualified beneficiaries.

Some states have not backed their tuition prepayment programs with the full faith and credit of the state, officials told us, because their state constitutions prohibit them from extending such a financial guarantee. That did not stop Ohio, however. In 1994, to better position the program as an integral part of the state, the legislature put on the ballot a measure that proposed amending the state constitution to back the tuition prepayment program with the state's full faith and credit. In the November election, state citizens approved the measure overwhelmingly.

Ohio officials also saw other advantages in this strategy. First, it allowed them to reduce the price of their benefits. Prior to approval of the ballot measure, Ohio had charged a premium on its tuition credits, so that in case IRS ruled that the program owed taxes on its investment earnings, it could pay the taxes without endangering the fund's actuarial soundness. The premium added significantly to benefit prices, which made them less appealing to purchasers and was also a factor in prompting the governor to question the program's value to purchasers, as described briefly in chapter 2. Second, Ohio officials believe that having the program backed by the state's full faith and credit will appeal to purchasers, making its guarantee seem more reliable.

Possible Shift From Deferred to Annual Tax on Participants Also a Major Concern

Although a private letter ruling pertains only to the taxpayer who requests it, program officials in other states have generally interpreted IRS's ruling on the tax consequences for MET purchasers and beneficiaries as applicable to their programs, too. Thus, program materials alert purchasers to the potential gift-tax liability, and each year program officials notify all beneficiaries using their benefits of the increased value of those benefits for federal income tax purposes. Although some program officials would ultimately prefer that both of these taxes be eliminated, they are generally not considered a hindrance to successful program operation. For example, although purchasers have to file gift tax forms, few will ever have to pay this tax, because a unified estate and gift tax credit of $192,800 can be used to shield them from gift tax liability. In addition, requiring students to pay taxes when they use their prepaid benefits does not create a disincentive for people to join these programs, two directors explained, because the potential tax burden on beneficiaries is likely to be small, given that students typically have very modest incomes and, therefore, are subject to low marginal tax rates.

Recently, however, program officials have become very concerned that IRS may change its opinion on the federal tax liability of program participants. IRS has indicated that regulations proposed by Treasury on contingent debt could be interpreted as applying to the transaction involved in state tuition prepayment programs; that is, the prepayment agreement would be considered a debt instrument. This interpretation could result in the owner of the benefits—either the purchaser or the beneficiary, depending on specific program details—being liable for federal income taxes annually on the imputed interest on his or her investment in the program. Thus, if a participant spent $1,000 on prepaid tuition benefits and the applicable interest rate was 5 percent that year, the participant could owe federal income taxes on $50.

Taxing participants this way would have a serious negative impact on program operations, according to several officials. First, they believe purchasers would not understand or be receptive to paying taxes on income they had not personally received, sometimes referred to as "phantom income." This tax requirement would make these programs seem more complex and much less attractive to potential purchasers, officials claim, which could decrease program sales significantly. Second, they claim that having to notify participants of their potential tax liability every year would impose an administrative burden on program operations. Some program officials recently expressed these views in letters to IRS and in testimony before IRS and Treasury officials on the proposed regulations.

Some Programs Awaiting IRS Rulings

In addition to MET, other state tuition prepayment programs have also sought IRS guidance on federal tax issues, but definitive answers to their questions have been delayed by the MET case and other factors. Like MET, four other programs we studied—those in Alaska, Florida, Ohio, and Pennsylvania—also took the precaution of requesting a private letter ruling from IRS to get clarification of the relevant federal tax issues.[56] But none of these four programs has received a ruling; Florida and Ohio have been waiting 5 years.

IRS officials told us they did not expect to issue rulings on any other tuition prepayment programs as long as the MET case was in litigation. But even though the Solicitor General recently decided not to appeal the MET case to the Supreme Court, rulings on other programs may not be immediately forthcoming for a variety of reasons. For example, IRS may wait until Treasury issues the final regulations on contingent debt, expected late this summer, because, as described earlier, they could have implications for how IRS would rule on the federal taxes applicable to program participants. In addition, IRS could decide to audit a state tuition prepayment program that it believes is liable for federal taxes on its investment earnings. If ordered to pay these taxes, the program might then challenge IRS in court, arguing—like MET did—that its investment earnings are tax exempt because the program is an integral part of the state.[57] While litigation was ongoing, other ruling requests could remain unanswered.

In general, IRS officials explained, state tuition prepayment programs raise issues of national significance with potentially far-reaching implications. For example, if states can implement prepayment programs for higher education expenses, perhaps they will try to start similar programs for the advance payment of other goods and services. These considerations require IRS to be very careful and circumspect in its analysis and ruling, officials said, which takes time.

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[56] Officials in Wyoming did not request rulings because they felt confident their program was designed in a way that would make its investment earnings tax exempt. On the advice of legal counsel, Alabama officials did not request an IRS ruling for similar reasons; however, the Director said they may decide to do so in the future.

[57] IRS's goal would be to have its position supported in a different Circuit Court of Appeals than the one where the MET case was decided, because once there is conflict between circuits, the chances are greater that the Supreme Court will become involved.

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Acknowledgments

In addition to the individuals listed above, the following staff members contributed significantly to this report: Tamara A. Lumpkin was responsible for the analysis of income data and helped write the report, Bob DeRoy and Paula J. Bonin did the computer programming, Regg Hatcher helped analyze program participation levels, and Julian Klazkin assisted with legal matters.

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